1-1-2010

# Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses, 10 Hous. Bus. & Tax L.J. 196 (2010)

Kathryn J. Kennedy
*John Marshall Law School*, kkenned@uic.edu

# EXCESSIVE EXECUTIVE COMPENSATION: PRIOR FEDERAL ATTEMPTS TO CURB PERCEIVED ABUSES

*By Kathryn J. Kennedy**


I. INTRODUCTION ..... 198
II. ATTEMPTS TO CURB ABUSES ..... 200
   A. *The Executive Pay Package* ..... 200
      1. Federal Tax Legislation ..... 203
      2. Options ..... 204
      3. Qualified Retirement Plan Limitations and Compensation Limitations ..... 205
      4. Corporate Hiring & Compensation Practices ..... 206
      5. Current Results ..... 207
   B. *I.R.C. § 162—An Indirect Attempt to Limit the Amount of Current Compensation* ..... 208
      1. I.R.C. § 162 Employer's Deduction for Compensation Limited for Actual Services and Reasonableness ..... 208
      2. Reasonableness ..... 210
      3. Evidence of Reasonableness ..... 212
      4. Conclusion ..... 213
      5. Similar Analysis in a Fiduciary Duty of Care and Loyalty Case ..... 213
   C. *I.R.C. § 162(m)—Indirect Attempt to Cap the Amount of Current Compensation* ..... 218
      1. The Purpose of § 162(m) ..... 218
      2. Unintended Consequences ..... 220
      3. Joint Committee on Taxation ..... 221
   D. *I.R.C. §§ 280G and 4999—Indirect Attempt to Limit Change of Control Payments* ..... 222
      1. The Purpose of §§ 280G and 4999 ..... 222
      2. Operation of I.R.C. §§ 280G and 4999 ..... 223
      3. Unintended Consequences ..... 225


---

* Kathryn J. Kennedy is a professor of law at The John Marshall Law School, teaching tax and employee benefits courses. She is the director of the graduate tax law program and the graduate employee benefits program. Special thanks to her colleague Susan Daley and research assistants Cam Moultrie, Eric Scarmardo, and Lisa Simioni for their excellent assistance in writing this article.

4. Conclusion .......... 226

E. *I.R.C. § 409A—Attempts to Limits Deferred Compensation* .......... 227

1. Rationale for Deferred Compensation .......... 227
2. Tax Rules .......... 227
3. New Rules of I.R.C. § 409A .......... 228
4. Unintended Consequences .......... 231

F. *I.R.C. § 457A—The Most Recent Attempt to Eliminate Deferred Compensation* .......... 231

G. *Federal Legislation of Corporate Governance—SOX* .. 232

H. *Other Legislative and Regulatory Attempts to Curb Excessive Executive Compensation* .......... 235

1. SEC Disclosure Rules .......... 236
2. NYSE Rules .......... 240

I. *Recent Legislative/Regulatory Attempts for TARP Recipients—Possible Templates for Future Initiatives* .......... 241

1. Presidential Campaigning .......... 241
2. Initial TARP Legislation for Certain Financial Institutions .......... 242
   a. Additional Limits on Current Compensation .. 243
   b. Additional Limits on Severance Compensation .......... 244
   c. Appropriate Standards for Executive Compensation and Corporate Governance .......... 245
3. Events in 2009 Leading to the Passage of ARRA .. 246
4. ARRA '09 .......... 247
   a. Severance Provisions .......... 248
   b. Clawback Provisions .......... 248
   c. Prohibition on Bonuses, Retention Awards and Incentive Compensation .......... 248
   d. Luxury Expenditures .......... 249
   e. The Board's Compensation Committee .......... 251
   f. Say-On-Pay .......... 251
   g. The Office of the Special Master for TARP Executive Compensation .......... 252
5. Current Status of TARP Recipients .......... 253
6. The Administration's Proposal .......... 253
7. Future Legislatives Initiatives .......... 255
8. Federal Reserve's Initiatives .......... 258

III. CONCLUSIONS .......... 259

## I. INTRODUCTION

Over the past century, Congress has routinely used the federal tax code[1] to affect and alter corporate behavior, even though corporate governance historically has been perceived to be within the states' police powers. In particular, Congress has been using the federal tax code to limit the amount and type of executive compensation being offered to corporate executives. Such result is not surprising given the tax implications for executives and corporations regarding such payments and the recent Congressional mandate that legislative proposals in the aggregate be deficit-neutral.[2] However, Congress's use of the tax code has not only failed in its application, such provisions have contributed to the complexity of the Code[3]—something that the prior and current administrations claim to eliminate—and they have also produced certain unintended consequences.

Given the recent meltdown of certain financial institutions resulting in a bailout through U.S. taxpayer dollars followed by the mega bonus grants by Goldman Sachs, J.P. Morgan, Merrill Lynch, and American International Group ("AIG"), the following questions regarding executive compensation have resurfaced—not only for Congress but also for the public—*how much* should be paid to the executives of these entities and whether they deserve *performance bonuses* in light of the financial ruin experienced by their employers. How we answer those questions, and whether we use the federal tax code and/or other federal

1. The Internal Revenue Code, 26 U.S.C., may be referred to as the "Code" in the text and will appear abbreviated as I.R.C. Many historians feel that the tax code should be used as the equalizer to prevent a more wealthy class of society from retaining more of its income.

2. It is no surprise that Congress is using the federal tax code in recent years more aggressively. For example, with the Budget Enforcement Act of 1990, Congress enacted that direct spending and tax legislation for a fiscal year has to be deficit-neutral in the aggregate. Such legislation was designed to curb new spending and to encourage justification for budget decisions. Budget Enforcement Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (codified as scattered sections of 2 U.S.C. & 15 U.S.C.). However, such legislation has led to excessive procedural impediments for tax relief legislation. *See* STAFF OF J. COMM. ON TAXATION, 107TH CONG., EXTENDING THE BUDGET ENFORCEMENT ACT: REVISION OF PAYGO RULES NECESSARY FOR BETTER TAX POLICY 3 (Comm. Print 2002).

3. I.R.C. § 7803(c)(2)(B) (2006) requires the National Advocate to prepare an annual report to Congress regarding legislative changes to make to the Code. According to a recent editorial in the *ABA Section of Taxation Newsquarterly*, there have been more than 3,250 changes to the tax code since 2001 (an average of more than one a day), including 500 changes made in 2008 alone. A 2001 study by the Joint Committee on Taxation estimated that the number of words in the tax code was over 1,395,000. Another tax research organization estimated that number to be at 2.1 million by 2005, indicating that the number of words had more than tripled since 1975. *The Complexity of the Tax Code*, 2009 A.B.A. SEC. OF TAX'N 12.

legislation or regulations to solve these types of problems, will have not only an impact on executives for those financial institutions, but likely executives at all publicly held employers.

The Obama administration initially pounced on this opportunity to suggest that salary caps be imposed on executive compensation to ensure that pay would be based on performance—that is, pegging compensation to numerical results. A similar view flows through the administration's views on medical care and educational reforms—find better ways to measure the quality of medical care or educational strides and compensate doctors/hospitals and educators based on their performance. As noted by one commentator, such attempts may result in unintended consequences—"there's a chance we'll get more of what we can measure—not what we truly want or need."[4]

In this article, the author will review prior congressional attempts to curb excessive executive compensation through the use of the federal tax code. The focus will then shift to other federal legislative and regulatory mandates that impact executive compensation—namely, the Sarbanes Oxley legislation, new Security and Exchange ("SEC") disclosure rules, and the New York Stock Exchange ("NYSE") rules. Next, the author will examine the tax and nontax legislative mandates imposed on the financial recipients of the Trouble Assets Relief Program ("TARP"), as such mandates may serve as a possible template for global changes in the future regarding executive compensation. While many objected to the federal government's interjection into the compensation arrangements of TARP recipients, the push back has been from the public as it regards itself as the majority or dominant shareholder of such TARP recipients and therefore, responsible to oversee executive compensation arrangements of its officers and directors. Finally, the author will critique what mandates are likely to be passed through legislation or regulation, which ones may result in "best practices," and which ones must wait another day.

4. David Wessel, *White House Rethinks How Best to Pay the Pros*, WALL ST. J., July 9, 2009, *available at* http://online.wsj.com/article/SB124709710389815145.html. Leonard E. Burman, who served as deputy assistant secretary for tax analysis at the Treasury Department from 1998 to 2000, joked that "every time [President Clinton] felt somebody's pain we got a proposal for a tax credit." Sam Young, *Conversations: Leonard E. Burman*, 124 TAX NOTES 325, 326 (2009), *available in* TAX NOTES TODAY, 2009 LEXIS TNT 141-8.

## II. ATTEMPTS TO CURB ABUSES

### A. *The Executive Pay Package*

A *typical* employee enjoys the following pay package: base salary (with or without overtime); a variety of employee benefits (e.g., medical/dental, life insurance, disability pay, dependent care assistance, and educational assistance); and perhaps a bonus, depending on the success of the business or a particular business unit. The typical *executive's* compensation package is radically different, relying less on base salary and more on incentive compensation to align the executive's interests with improvements in the employer's long-term and short-term financial growth. Thus, an executive's overall compensation package could consist of the following items:

- Base salary (paid weekly, bimonthly, monthly, etc.);[5]
- Bonuses and other incentive compensation
  - Signing bonuses (e.g., one-time bonus to compensate the executive for the loss of a current year's bonus and/or equity awards that he/she would have received from the prior employer); and
  - Individual and/or group incentive plans, which may result in additional compensation if certain standards or performance measures are met (these plans can be based on short term or long term goals);
- Equity compensation[6]

---

5. The typical Wall Street bank model focuses on low base salary levels relative to incentive pay. *Bank of America May Increase Salaries for Investment Bankers*, BLOOMBERG, Mar. 30, 2009, http://compliancex.typepad.com/compliancex/2009/03/bank-of-america-may-increase-salaries-for-investment-bankers.html.

6. The choice of equity-based awards goes beyond compensation strategy as such choices have different accounting and financial reporting issues, tax-related issues (for the employer and the employee), SEC disclosure requirements, as well as the possible impact on the company's stock. According to Michael Brush, five of the most overpaid CEOs during 2008 were: James Steward of BJ Services, an oilfield services company, made $34.6 million, mostly from cashing his stock options; John Faraci of International Paper made $38.2 million, including $21 million in pension payments; Brian Roberts of Comcast received $40.8 million, including $22 million in cashing out stock options and a $7.4 million bonus; Michael Jeffries of Abercrombie & Fitch received $71.8 million, including a $6 million "stay bonus"; and Eugene Isenberg of Nabors Industries, an oil and gas drilling company, got $79.3 million, including a $58.7 million bonus. Posting of Michael Brush to Money Blog Top Stocks (Oct. 2, 2009, 09:07) (on file with The Houston Business & Tax Law Journal).

- oStock options (discounted or at market value) which directly tie compensation to the growth in the corporation's financial value;
- oRestricted stock or restricted stock units (e.g., must be held for a minimum period of time) and performance-based shares and performance-based units; and
- oPhantom stock or stock appreciation rights ("SARs") (e.g., the ability to achieve the stock appreciation value without actually owning the company stock);

•Employee pension/profit-sharing benefits and insurance benefits

- oQualified pension/profit-sharing benefits and nonqualified Supplemental Executive Retirement Plans (known as "SERPs");
- oVoluntary deferrals of compensation and/or bonuses by the executive; and
- oLife insurance and supplemental life insurance;

•Severance arrangements and early window plans

- oEarly window plans that subsidize the cost of retiring early under the employer's qualified and/or nonqualified retirement plan;
- oGolden parachute arrangements (i.e., increased severance pay in the event that the involuntary termination is due to a change of control of the employer); and
- oContinuation of health and welfare benefits after severance;

•Perquisites[7]

- oClub memberships;
- oPersonal loans with below market interest rates;[8]

---

7. *See* STEVE SABOW, EXECUTIVE PERQUISITES: A CHANGING LANDSCAPE (Hay Group 2009) (on file with The Houston Business & Tax Law Journal) (taking a sample of 200 companies, all with revenues in excess of $5 billion) [hereinafter referred to as EXECUTIVE PERQUISITES]. "All but nine of the companies disclosed providing at least one perk to their executives." Six disclosed providing no perks, and three disclosed not providing perks below the aggregate value requiring disclosure. The most common perks in the WSJ 2008 Study are personal use of corporate aircraft (66%), financial planning (58%), company cars (52%), tax gross-ups (46%), and personal physical exams (40%). Pressure from shareholders and institutional investors has caused companies to scrutinize such executive perks due to the lack of linkage to corporate performance. Companies that do offer such perks do so to make the executives more productive and efficient. *Id.*

- oRelocation expenses;
- oUse of corporate aircraft, company cars or home-office equipment for the executive and/or spouse;
- oCadillac health plans and executive physicals; and
- oTax "gross-ups" or excise tax "gross-ups" (e.g., covering the taxes incurred by the executive for certain employee benefits such as club membership, corporate jets, golden parachute payments, or excise taxes imposed as a result of fringe benefits).

Generally, compensation is paid either currently (and is therefore taxed currently, unless a tax exclusion or exemption applies, such as employer-provided medical coverage or benefits under a qualified pension/profit-sharing plan) or deferred (and therefore is generally not taxed until paid or vested). Deferred compensation generally is provided through voluntary or involuntary deferrals of income. An executive may voluntarily defer a portion of his/her compensation and/or bonus. Alternatively, the employer may defer a portion of the executive's compensation as a useful reward and retention tool in the hands of the employer. If and only if certain performance standards are satisfied, the deferred compensation is paid, or the employee must stay employed with the employer for a minimum period of time in order for the deferred compensation to vest.

Best practices tie executive compensation closely to performance. Using metrics related to financial, operational, and strategic targets, compensation can be formulated so as to maximize both short term and long term goals.[9] The financial

8. The passage of the Sarbanes-Oxley Act of 2002 (SOX), also known as the Public Company Accounting Reform and Investor Protection Act of 2002, was approved by the U.S. House by a vote of 334-90 and by the U.S. Senate by a vote of 99-0, making this benefit largely unavailable for publicly held companies. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402, 116 Stat. 745, 787 (codified as amended at 15 U.S.C. § 78(m) (2006)). Section 402 of SOX prohibits loans to the directors or executive officer of a public company. *Id.*

9. *See* SCOTT E. LANDAU ET AL., EXECUTIVE PAY REFORM POSES COMPLEX RISKS FOR COMPENSATION COMMITTEES 4 (2009), www.pillsburylaw.com/compensationreform insights. As the shareholders' goals are to attain better company performance and higher investment returns, requiring top executives to purchase and retain company stock is consistent with aligning their interests with that of the shareholders. The RiskMetrics Group (RMG) is the former Institutional Shareholders Services (ISS), founded to promote good corporate governance in the private sector and to heighten the level of responsible proxy voting by institutional investors. It makes recommendations to its clients regarding the approval of equity compensation packages and the election of incumbent board of directors or management. Equity plans for shareholder approval are evaluated

bailout of the TARP recipients has triggered renewed interest in using risk assessment of such compensation packages.[10] The RiskMetrics Group ("RMG") is a leading proxy advisor especially for institutional investors and provides voting guidelines on withholding votes for board and compensation committee members and on equity compensation arrangements.[11] In light of the recent financial turmoil, there has been greater shareholder scrutiny on executive compensation. As a result, more companies pay greater attention to the RMG guidelines regarding shareholder votes. Throughout this paper, the author will indicate what practices RMG deems to be "poor practices" that could result in withholding a positive vote.

The following reasons explain the growth in the increase of base and non-base current and deferred compensation for executives:

### 1. Federal Tax Legislation

First, as described below, federal legislation aimed at reining in perceived abuses has actually had the unintended effect of legitimizing certain compensation practices. Introduced by the Deficit Reduction Act of 1984, I.R.C. § 280G intended to limit the awards payable to executives under change-in-control agreements.[12] Instead, this Code section was viewed as tacit approval by the government of these arrangements as long as the award provided did not exceed three times base compensation. Indeed, "hundreds of companies that had no change-in-control agreements" introduced these arrangements soon after I.R.C. §

---

in the context of whether such plans provide poor pay practices that potentially could result in RMG's recommendation for a withholding vote on compensation committee members. *See generally Proposed Best Practices in Executive Compensation Disclosure*, RISKMETRICKS GROUP, http://www.riskmetrics.com/node/ 135612 (last visited Feb. 17, 2010).

10. The fear is executives may engage in excessive levels of risk to achieve short-term gains that are in their best interests, but not necessarily in the best interest of the employer. *See* Press Release, Treasury Secretary Tim Geithner, Statement on Executive Compensation (June 10, 2009), *available at* http://www.ustreas.gov/press/releases/tg163.htm; JAMES F. REDA, FINANCIAL EXECUTIVE, EXECUTIVE COMPENSATION: BALANCING RISK, PERFORMANCE AND PAY 1 (2009), http://www.jfreda.com/pdf_documents/Balancing-Risk-Performance-and-Pay.pdf?webcode=mag_detail&key=85ffa047-17c6-497d-936d-8f94872624c6.

11. *See generally* RiskMetrics Group, Our Company, http://www.riskmetrics.com/our_company (last visited Jan. 29, 2010 ) (stating that RiskMetrics Group accomplishes its visions "[b]y . . . encouraging transparency and access for all market participants, and, [providing a forum for] collaboration across market participants . .  ").

12. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 67(a), 98 Stat. 494, 585 (1984) (adding § 280G to the I.R.C.).

280G was enacted.[13] A similar result can be seen with I.R.C. § 162(m), which was introduced by the Omnibus Budget Reconciliation Act of 1993.[14] Interpreted by many as defining the $1 million deduction limit as reasonable pay, many companies raised base pay to this level shortly after enactment.[15]

2. Options

One reason for option proliferation was the widely held belief among many companies that options represented a low-cost method of compensation.[16] Prior to the changes in the accounting rules,[17] option awards with an exercise price at least equal to the fair market value at the date of grant required no accounting treatment and no cash outlay, resulting in the perception that the cost of the award to the company was lower than the actual economic cost.[18] This was particularly true in the dot com era, where start-ups seduced employees with large stock option grants, thereby requiring more traditional firms to follow suit in an effort to retain managerial talent.[19]

A second reason was the carve-out of performance-based compensation from the $1 million compensation limit of I.R.C. § 162(m), thereby specifically approving the use of stock options. While one can argue whether the use of options was legitimized by the enactment of I.R.C. § 162(m) or by the changing views on the basis of executive incentive (i.e. from focus on company size to the increase in shareholder value),[20] it is clear that the increased use of options has contributed to compensation growth

---

13. Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them* 28 (Harv. Bus. Sch. NOM Working Paper No. 04-28; ECGI Finance Working Paper No. 44/2004, 2004), *available at* http://ssrn.com/abstract=561305.

14. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993) (codified in scattered sections of the U.S.C.).

15. Jensen, *supra* note 13, at 30.

16. *Id.* at 37.

17. FASB Statement No. 123 ("Statement 123") established the fair value based method, under which the cost of stock option awards are accounted for at their fair value as of the date of grant, but did not require companies to use this method. *See* ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Fin. Accounting Standards No. 123, §§ 11, 16-44 (Fin. Accounting Standards Bd. 1995). Statement 123 was revised in 2004 to require stock-based compensation cost to be expensed using the fair value method. SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards No. 123(R), §§ 15–16 (Fin. Accounting Standards Bd. 2008); *see also* ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 62-65 (Blackwell Publishing 2008) (1995).

18. Jensen, *supra* note 13, at 39.

19. Jeffrey N. Gordon, *Executive Compensation: If There's a Problem What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675, 687 (2005).

20. *Id.* at 680-82.

in several ways. First, because option value correlates highly with stock price, the bull market of the 1990s caused the value of granted options to skyrocket, making options a highly desirable form of compensation. For example, from 1992 through 1998, it is estimated that the annual dollar value of option awards to chief executive officers ("CEOs") increased by more than 300%, at the same time the S&P 500 index more than tripled.[21] Further, this effect is magnified when one considers that most option plans permit recipients to benefit from short spikes in share value even when long-term performance is not as robust![22]

#### 3. Qualified Retirement Plan Limitations and Compensation Limitations

With the advent of the Employee Retirement Income Security Act of 1974 ("ERISA"), maximum limitations were imposed on *qualified* defined benefit and defined contribution plans.[23] Initially, the maximum dollar amount available under a qualified defined benefit plan was an annual benefit of $75,000 commencing after 55 and the maximum dollar allocation available under a qualified defined contribution plan was $25,000,[24] both indexed with cost of living adjustments. By 1982, the maximum dollar limits had risen to $136,425 and $45,475, respectively. Thus, Congress lowered the maximum dollar limits to $90,000 and $30,000, respectively, thereby reducing the maximum amount a participant could accumulate under a qualified plan.[25] Later, through the advent of the Tax Reform Act of 1986 ("TRA '86"), Congress added an annual compensation ceiling to the qualification rules of $200,000 to be adjusted annually with cost of living increases.[26] When that limit reached $235,840 in 1993, Congress again lowered the maximum annual compensation ceiling to $150,000 to be adjusted annually for cost of living adjustments in $5,000 increments.[27]

---

21. Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 123-24 (2000).

22. Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 666 (2005).

23. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2004, 88 Stat. 829, 979-87 (adding § 415 to the I.R.C.).

24. *Id.* § 2004(a)(2), 88 Stat. at 980-81.

25. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 235(a), 96 Stat. 324, 505 (1982).

26. Tax Reform Act (TRA) of 1986, Pub. L. No. 99-514, 100 Stat. 2088, § 1106(d)(1) (codified at I.R.C. § 401(a)(17) (2006)).

27. *Compare* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13212, 107 Stat. 312, 471 (stating that the adjustments should be in increments of $10,000) *with* I.R.C. § 401(a)(17) (2006) (stating that the adjustments should be in

Although I.R.C. §§ 401(a)(17) and 415 require the Service to periodically adjust the dollar limitations for cost-of-living increases, such periodic increases clearly do not keep pace in the world of executive compensation.[28] Thus, in an effort to make executives "whole" with respect to their retirement savings, companies instituted SERPs.[29] This was especially important in light of Congress's repeated efforts to reduce the maximum amounts permitted under qualified plans.

#### 4. Corporate Hiring & Compensation Practices

In addition to increases resulting from competition for talent, some commentators believe that corporate hiring practices are also responsible for executive pay increases. One trend is the growing practice of filling executive positions with external candidates rather than from within the organization. Typically, external hires receive greater compensation packages than internal candidates.[30] For example, in 1970, less than 15% of the CEO openings among Fortune 500 companies were filled with external hires, in contrast with the 1990s where this amount exceeded 25%.[31]

In the normal scenario, when a corporation is courting a high-level executive, the Board of Directors engages a search firm to identify qualified candidates.[32] After whittling down the pool of applicants, a finalist is selected and the negotiation of a compensation package begins.[33] In this scenario, the board of directors is negotiating from a weakened position. When considering that most compensation committees lack the "negotiating skills necessary for hard-nosed contract

---

increments of $5,000); *see also* Barry J. Bidjarano, *Coping with the Reduced Limitation on "Compensation" Used Under Qualified Retirement Plans*, 68 ST. JOHN'S L. REV. 357, 358 (1994) (stating that the 1993 $235,840 limit would be reduced in 1994).

28. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 611, 115 Stat. 38, 96 (2001) reset many of the statutory dollar amounts previously adjusted on an annual basis under I.R.C. § 415 (2006) and the Pension Protection Act of 2006, Pub. L. No. 109-280, § 303, 120 Stat. 780, 921-23 (2006). It also ensured that the adjusted limitations will not revert back to the prior pre-EGTRRA levels, but the limitations are still restrictive and alone cannot be used as an effective toll to attract and retain key executives.

29. However, note that employers also provide SERPs and other deferred compensation arrangements that are structured without regard to the terms of the qualified plans. Thomas Veal & Laura Morrison, *SERP Shifts and Sec. 409A*, http://www.thefreelibrary.com/SERP+shifts+and+Sec.+409A.-a0160760183 (last visited Feb. 5, 2010).

30. Jensen, *supra* note 13, at 34.

31. *Id.* at 32.

32. *Id.* at 51.

33. *Id.*

negotiations,"[34] and that many potential executives hire professional representation to carry out these negotiations, it is of little surprise that companies tend to overpay external candidates.[35]

Similarly, regarding compensation negotiations for internal hires or reviews of compensation arrangements for existing executives, general corporate procedures still tend to favor rich compensation arrangements.[36] While this is changing, compensation committees of the employers' boards of directors may not meet frequently throughout the year, thereby relying more on compensation analysis produced by the internal human resources department or some other group that may be under the control of the executive whose compensation is at issue.[37] Further, when outside consultants or advisors are utilized to gain market knowledge, there is a bias towards compensation levels that are above average; a practice that has lead to "an ever-increasing average and a continuous escalation of executive pay."[38] Finally, the board and the compensation committee may operate under an unintended bias, resulting from their personal relationship and friendship with the executive, or possibly from their own prior experience.[39] This may be particularly true where the board member was previously in a position similar to that of the executive at issue, and the board member received a compensation package similar to that under consideration.[40]

5. Current Results

In the 2008 report by the Institute for Policy Studies, the CEOs of the financial firms receiving TARP money were paid on average 34 times President Obama's $400,000 salary, even though those same firms laid off a combined number of 160,000 workers.[41] From 2006 through 2008, the top five executives at the 20 banks that accepted the most TARP money averaged $17.8 million *each* in personal compensation.[42] According to the 2009 report by the Institute for Policy Studies, "[a] generation ago, . . .

---

34. *Id.* at 50.
35. *Id.* at 52.
36. *See* Jensen, *supra* note 13, at 50-51.
37. *Id.* at 50.
38. Bebchuk & Fried, *supra* note 22, at 657.
39. *Id.* at 656.
40. *See id.* at 657.
41. Sarah Anderson et al., *America's Bailout Barons: Taxpayers, High Finance, and the CEO Payout Bubble*, 16 INST. FOR POL'Y STUDIES 7, 10 (2009), *available at* http://www.ips-dc.org/reports/.
42. *Id.* at 23-25.

top corporate executives seldom earned much more than 30 to 40 times [what their workers took home]. In 2008, . . . top executives averaged 319 times more [pay] than average [U.S. workers]."[43] The report concludes that such excessive executive compensation packages impose a "massive obstacle" to economic recovery.[44] In fact, back in November of 2008, former Federal Reserve chair Paul Volcker blamed "excessive pay packages" for the resulting failing financial markets.[45]

While it is easy for Congress to point to the pay packages for the TARP recipients and the excessive compensation of particular individuals, such compensation may not be representative of the packages available to most executives. According to the Hay Group's 2008 CEO compensation study, a slightly different picture is revealed—CEO compensation in 2008 actually declined "for 200 companies with more than $5 billion in annual revenue."[46] However, base pay "increased 4.5% to $1,083,000, annual incentives declined 10.9% to $1,241,000, [producing] an overall cash compensation decrease of 8.5%."[47] If one factored in long term incentives as part of the annual pay package, total direct compensation dropped 3.4% to $7,562,000.[48] However, shareholders may not agree that these declines are sufficient as "[t]he median company declined 5.8 percent in net income from 2007, and had a one year total shareholder return ("TSR") of -31.8 percent."[49]

### B. *I.R.C. § 162—An Indirect Attempt to Limit the Amount of Current Compensation*

#### 1. I.R.C. § 162 Employer's Deduction for Compensation Limited for Actual Services and

---

43. *Id.* at 2.

44. *Id.*

45. *See* Larry Elliott, *Volcker: Executive Pay Broke the Financial System*, SYDNEY MORNING HERALD, Nov. 19, 2008, *available at* http://business.smh.com.au/business/volcker-executive-pay-broke-the-financial-system-20081118-6abo.html; *see also* Forum, *FSF Principles for Sound Compensation Practices*, FIN. STABILITY BD. 1 (2009) (stating that "[c]ompensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialized.").

46. EXECUTIVE PERQUISITES, *supra* note 7, at 1.

47. *Id.*

48. *Id.*

49. *Id.*

Reasonableness

For the past century, I.R.C. § 162 has allowed deductions for all employers for "ordinary and necessary" business expenses and "reasonable allowance for salaries or other compensation for personal services actually rendered."[50] This reasonable standard is relevant not only for current salaries paid to executives, but also for deferred compensation paid to executives. Under the rules of I.R.C. § 404(a), which govern the deductibility of deferred amounts paid to employees, compensation paid under a deferred arrangement must also satisfy the reasonable compensation rules of I.R.C. § 162.[51]

Throughout its history, the Service has attempted to use the reasonable compensation standard of I.R.C. § 162 to curb what it perceived to be excessive executive compensation.[52] In fact, I.R.C. § 162 was amended in 1993 to indirectly limit the amount paid to an executive by denying any deductions for compensation paid by a publicly held corporation to a "covered employee" in excess of $1 million.[53] This limitation will be discussed in the next section of the article. While the $1 million deduction cap is applicable to publicly held corporations, the requirement of "services"[54] and "reasonableness"[55] under I.R.C. § 162 is critical for deductions of privately held or closely held businesses, not subject to the $1 million cap, and for deductions of publicly held businesses for compensation based on performance, also not subject to the $1 million cap. According to one practitioner, a senior member of the Senate Finance Committee formally

50. I.R.C. § 162(a)(1) (2006 & Supp. 2009). The reasonable compensation requirement was added by the Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057 (1919). I.R.C. § 404 has a similar reasonability requirement for compensation paid pursuant to a deferred compensation plan. I.R.C. §§ 162, 404 (2006 & Supp. 2009).

51. *See* Treas. Reg. § 1.404(b) (as amended in 1963) (stating that "[i]n order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162" and prohibiting a deduction for amounts in excess of a "reasonable allowance for compensation for the services actually rendered"). These regulations were last amended in 1963 when I.R.C. § 404(a) explicitly referenced I.R.C. § 162 in ascertaining whether an expense for deferred compensation would be permitted. *Id.* While the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1851(b)(2)(C)(i), 100 Stat. 2085, 2863 removed the reference to I.R.C. § 162 from § 404(a)(5), the legislative history affirms Congress's intention to broaden § 404(a)(5) to refer to all forms of compensation. Albertson's Inc. v. Comm'r, 42 F.3d 537, 544-546 (9th Cir. 1994).

52. *See* Stuart M. Lewis, *Reasonable Compensation – Alive and Well?*, BNA TAX & ACCOUNTING, June 2, 2009, http://www.bnatax.com/insightsdetail.aspx?id=3944.

53. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211(a), 107 Stat. 312, 469-70 (adding a new subsection (m) to I.R.C. § 162 for tax years beginning on or after January 1, 1994).

54. Treas. Reg. § 1.162-7(a) (2009).

55. *Id.*

recommended the Service renew its efforts to curb excessive executive compensation through the reasonable compensation standard of I.R.C. § 162.[56] Thus, it may become of greater concern to all employers.

The deduction requirement has two prongs in the compensation context—whether services were actually rendered and whether those services were reasonably compensated in the form of salaries and other compensation.[57] When payments are made to owner-employees of a business, the issue arises as to whether the payment is for services (and therefore a salary) or whether the payment is a dividend (a return on the owner's investment).[58] Such issues are critical to both the employer and the owner-employee as salary is deductible to the employer whereas dividends are not, and the tax rates for the owner-employee differ depending on whether the payment is compensation or dividends.[59]

2. Reasonableness

Assuming that services were actually rendered, the concept of "reasonableness" is then raised.[60] The Service's regulations require an objective analysis of the compensation (i.e., "such amount as would ordinarily be paid for like services by like enterprises under like circumstances").[61] The Internal Revenue Manual advises auditing revenue agents to take into account 12 different factors in evaluating the reasonableness of compensation.[62] Such a test involves a question of fact, generally determined on a case-by-case basis.[63]

---

56. *See* Lewis, *supra* note 52.

57. *See* Paula Constr. Co. v. Comm'r, 58 T.C. 1055, 1058 (1972), *aff'd by* 474 F.2d 1345 (5th Cir. 1973).

58. *See id.* at 1058. The leading case on the issue, stated that "[i]t is now settled law that only if payment is made with the intent to compensate is it deductible as compensation . . . . Whether such intent has been demonstrated is a factual question to be decided on the basis of the particular facts and circumstances of the case." *Id.* at 1058-59.

59. I.R.C. § 162 (2006).

60. Treas. Reg. § 1.162-7 (2009).

61. Treas. Reg. § 1.162-7(b)(3).

62. INTERNAL REVENUE MANUAL § 4.35.2.5.2.2 (2006), *available at* http://www.irs.gov/irm/part4/irm04-035-002.html (listing the following factors as relevant: nature of employee's duties; his/her background and expertise; his/her knowledge of the business; size of the employer; his/her contribution to the profitability of the employer; time spent; economic conditions, both locally and generally; character and level of responsibility of the employee; time the compensation is determined; relationship of shareholder's compensation to stockholdings; whether compensation is in part or in full for payment of business or assets acquired; and amount paid by similarly situated employers to similar employees for similar services).

63. Perlmutter v. Comm'r, 373 F.2d 45, 47 (10th Cir. 1967).

The courts have considered as many as 21 criteria in fashioning this standard, but the most used factors include (1) the employee's qualifications/skills, (2) the employee's contribution to the profitability of the employer, (3) the employee's compensation relative to employees in general, and (4) the employee's salary relative to the industry.[64]

While courts may weigh the various factors differently, courts appear to take two basic approaches in applying the factors. Under the multiple factor approach, the court takes into account many different factors, including, but not limited to, the employer's financial size, health, and complexity, as well as comparison of the compensation based on similarly situated employers.[65] Such approach has been criticized by the Seventh Circuit as "too vague, and too difficult to operationalize, to be of much utility."[66] Since all businesses are different, one would expect compensation packages for executives to be different. In rejecting the multiple factor approach, the Seventh Circuit stated that such a test "invites the Tax Court to set itself up as a super personnel department for closely held corporations, a role unsuitable for the courts . . . ."[67]

Other courts adopt the independent investor approach, in which the court takes the perspective of a hypothetical independent investor (with no management role) to determine the reasonableness of the employee's compensation.[68] The test considers whether payment of the compensation adversely affected the rate of return from the viewpoint of an independent

---

64. *See* Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949) (setting forth eight factors: "the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; . . . the salary policy of the taxpayer as to all employee; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years."); *see, e.g.*, Edwin's Inc. v. United States, 501 F.2d 675, 677 (7th Cir. 1974) (listing seven factors); Foos v. Comm'r, 41 T.C.M. (CCH) 863, 878-79 (1981); Diverse Indus., Inc. v. Comm'r, 51 T.C.M. (CCH) 525, 529 n.3 (1986); Kennedy, Jr. v. Comm'r, 671 F.2d 167, 173-74 (6th Cir. 1982) (listing fifteen factors); Edwin's Inc. v. Comm'r, 716 F.2d 1241 (9th Cir. 1983) (listing five factors); Trucks, Inc. v. United States, 588 F. Supp. 638, 642-43 (D. Neb. 1984) (listing fifteen factors).

65. *See, e.g.*, Eberl's Claim Serv. v. Comm'r, 249 F.3d 994, 999 (10th Cir. 2001); Alpha Med., Inc. v. Comm'r, 172 F.3d 942, 946 (6th Cir. 1999).

66. Menard, Inc. v. Comm'r, 560 F.3d 620, 622-23 (7th Cir. 2009). According to Judge Posner, "All businesses are different, all CEOs are different, and all compensation packages for CEOs are different." *Id.* at 623.

67. Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 835 (7th Cir. 1999).

68. *See, e.g.*, Dexsil Corp. v. Comm'r, 147 F.3d 96, 100-01, 103 (2d Cir. 1998); *Exacto Spring Corp.*, 196 F.3d at 838; Labelgraphics, Inc. v. Comm'r, 221 F.3d 1091, 1095 (9th Cir. 2000).

shareholder.[69] Courts find evidence of comparable compensation in a given industry to be effective evidence of the reasonableness of the compensation.[70] Of course, comparability within the industry may be misleading, as executive pay is generally set according to benchmarks within the industry and most businesses wishing to be judged in the top 50% will pay at or above the 50% benchmark. To the extent that all businesses aspire to attract and retain the best executives, pay is artificially raised as the bar is raised (referred to as the Lake Wobegon effect).

The Tax Court recently has taken an approach somewhere in the middle—rejecting the multiple factor approach but applying the multi-factor test through the lens of an independent investor.[71] Hence, each component of the executive's compensation is viewed separately to determine if it is reasonable.[72]

3. Evidence of Reasonableness

Courts have also made their own determination as to what constitutes reasonable compensation that differs from that of the taxpayer and/or the Service, leading to uncertainty. Most recently, the Sixth and the Ninth Circuits reversed the Tax Court for its failure to discuss its rationale for what constituted reasonable compensation, as it differed from that of the taxpayer and the Service. In *Alpha Medical, Inc. v. Commissioner*, the employee-shareholder received $4,439,180 in compensation, an increase of over $4 million from the prior year.[73] The Service claimed that the amount in excess of $400,000 was unreasonable and, therefore, not deductible.[74] The Tax Court ruled that $2.3 million was reasonable compensation.[75] Upon review, the Sixth Circuit determined that the taxpayer met its burden of proof, and thus the Tax Court's unsubstantial determination as to what is a reasonable level was a clear error.[76] Similarly in *Leonard*

---

69. JAMES F. REDA ET AL., COMPENSATION COMMITTEE HANDBOOK 199 (3rd ed. 2008).

70. *See, e.g.*, Rutter v. Comm'r, 853 F.2d 1267, 1273 (5th Cir. 1988) (citing this as "the most significant factor"); Jones Bros. Bakery, Inc. v. United States, 411 F.2d 1282, 1291 (Ct. Cl. 1969); Shiocton Lumber Co. v. Comm'r, 33 T.C.M. (CCH) 599, 606 (1974); Leonard J. Ruck, Inc. v. Comm'r, 28 T.C.M. (CCH) 63, 69 (1969).

71. *See* Miller & Sons Drywall, Inc. v. Comm'r, 89 T.C.M. (CCH) 1279, 1282 (2005).

72. *Id.* at 1284-89.

73. Alpha Med., Inc. v. Comm'r, 172 F.3d 942, 943, 951 (6th Cir. 1999).

74. *Id.* at 943.

75. *Id.*

76. *Id.* at 944, 951.

*Pipeline Contractors, Ltd. v. Commissioner*, the employee was paid a bonus of $1.68 million in addition to his base salary of $97,800.[77] The Service determined that only $135,207 was reasonable and therefore deductible, whereas the Tax Court held that $700,000 was reasonable.[78] The Ninth Circuit remanded the case to the Tax Court to explain how it ascertained an amount of $700,000.[79]

4. Conclusion

As the rules of I.R.C. § 162(a) have resulted in an individual facts and circumstances test, it has made it exceedingly more difficult for the Service to audit and pursue. The recent Seventh Circuit decision in *Menard* also raises the issue of whether the courts are the best arbitrators of what reasonable compensation is.[80] But given the fact that denial of an I.R.C. § 162(a) deduction penalizes the employer and not the employee, it is not much of a lever in controlling the size of executive compensation.

5. Similar Analysis in a Fiduciary Duty of Care and Loyalty Case

In a matter concerning the alleged violation of fiduciary duties under § 36(b) of the Investment Company Act of 1940, the Seventh Circuit affirmed the district court's opinion, finding in part that fees for an investment advisor that were roughly identical in both level and breakpoints as those that other funds of similar size and investment goals paid their advisors, and otherwise had a fee structure that was lawful under the Investment Advisers Act, were not excessive.[81] In its opinion, the court analogized that the procedures used to establish the reasonableness of fees sought by investment advisors are the same as the procedures used by a company's board of directors to

---

77. Leonard Pipeline Contractors, Ltd. v. Comm'r, 142 F.3d 1133, 1134 (9th Cir. 1998).

78. *Id.* at 1134-35.

79. *Id.* at 1135-36.

80. *See* Menard, Inc. v. Comm'r, 560 F.3d 620, 622-23 (7th Cir. 2009) The court opined that courts had attempted to operationalize the multifactor reasonable salary standard but found the standard vague, difficult to apply, and failed to provide an objective basis for a judicial decision. *Id.*

81. Jones v. Harris Assoc. L.P., 527 F.3d 627, 631 (7th Cir. 2008) (citing 15 U.S.C. § 80(b)-(5) (1940)); *see also* Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982) (noting that under state corporation laws, boards of directors of corporations have fiduciary obligations under the business judgment rule to assure that compensation levels are not abusive to shareholders; such duty also requires that the board make an informed decision regarding compensation levels).

establish compensation for its top managers.[82] The court noted that, "[no] court has held that this procedure implies judicial review for 'reasonableness' of the resulting salary, bonus, and stock options."[83] In a subsequent dissenting opinion, Judge Posner opined in dicta that "courts do not review corporate salaries for excessiveness. That misses the point, which is that unreasonable compensation can be evidence of a breach of fiduciary duty."[84]

Even though Judge Posner in his dissent is undoubtedly concerned with a governance structure that allegedly enables mutual fund advisers to charge exorbitant fees, he does not elaborate upon how the same structure exists in the establishment of executive compensation. If an abusive structure does exist in the establishment of executive compensation (as has been argued by certain commentators),[85] that does not seem to translate into an appropriate issue for judicial review absent some other form of corporate malfeasance. In most cases, issues concerning executive compensation should remain a matter of corporate governance.

---

82. *Jones*, 527 F.3d at 632-33.

83. *Id.* at 633.

84. *Id.* at 732 (Posner, J., dissenting).

85. *See, e.g., Executive Compensation II: CEO Pay and the Mortgage Crisis: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 3 (2008) (statement of Dr. Susan M. Wachter, Richard B. Worley Professor of Financial Management, University of Pennsylvania), *available at* http://oversight.house.gov/images/stories/documents/20080307103022.pdf (opining that "[m]isaligned incentives in compensation systems are at the core of the current financial market and housing market linked crises"); *Executive Pay: The Role of Compensation Consultants: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 1 (2007) (statement of Charles M. Elson, Director, John L. Weinberg Center for Corporate Governance, University of Delaware), *available at* http://oversight.house.gov/images/stories/documents/20071205102251.pdf (arguing that "[p]ay unrelated to performance is a result of the failure of effective bargaining between the corporate board and management"); *Executive Pay: The Role of Compensation Consultants: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 8 (2007) (statement of Meredith Miller, Assistant Treasurer for Policy, Office of the Connecticut State Treasurer Denise L. Nappier), *available at* http://oversight.house.gov/images/stories/documents/20071205102335.pdf (arguing for additional reform in executive compensation systems); *Executive Pay and the Role of Compensation Consultants: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 5 (2007) (statement of Houman B. Shadab, Senior Research Fellow, Mercatus Center at George Mason University), *available at* http://oversight.house.gov/images/stories/documents/20071205102744.pdf (arguing that there are potential conflicts of interest among executive compensation consultants); MAJORITY STAFF OF H. COMM. ON OVERSIGHT & GOV'T REFORM, 110TH CONG., EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS 3–9 (Comm. Print 2007), *available at* http://oversight.house.gov/images/stories/documents/20071205100928.pdf (discussing key findings concerning executive compensation consultants); *but see Executive Pay: The Role of Compensation Consultants: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 2–3 (2007) (statement of Charlie Scott, President of Mercer's Human Capital Consulting Business) (on file with The Houston Business & Tax Law Journal).

Both directors and executive officers of public companies owe shareholders a fiduciary duty of care and loyalty.[86] Notwithstanding, neither of the Seventh Circuit's decisions distinguishes between these general duties that may arise in the context of executive compensation versus the fiduciary duties that may arise in the true issue at hand in the *Jones* decisions (i.e., whether there was a violation of fiduciary duties under § 36(b) of the Investment Company Act of 1940). As such, the Seventh Circuit seems to be creating a slippery slope in matters pertaining to corporate governance by comparing apples to oranges.

If the dissent had opined that courts should review whether a TARP recipient has appropriately followed the requirements under TARP, everyone would likely agree these measures may be appropriate. However, a review of compensation as a matter of course by the courts in most matters is merely a review of a discretionary function, which should remain a matter of corporate governance.

In a very publicized case, *In re The Walt Disney Co. Derivative Litigation*, there was a shareholder derivative suit under state law alleging that the board members of the Walt Disney Company committed waste and breached various fiduciary duties under state law by "blindly approv[ing]" the employment agreement with Michael Ovitz as president of the company.[87] According to the facts in the complaint, the compensation committee had not been provided with a draft of Mr. Ovitz's employment agreement, only with a summary of its terms and conditions.[88] Nevertheless, the board approved of Mr. Ovitz's hiring and permitted CEO Eisner (a close friend of Ovitz's) to work out the details of the agreement.[89] Under a non-fault termination clause, Mr. Ovitz terminated employment a year later and was afforded a very generous severance package.[90] The Chancery Court denied the defendants' motions to dismiss as the facts alleged in the complaint implied "that the defendant directors *consciously and intentionally disregarded their responsibilities,* adopting a 'we don't care about the risks' attitude

86. *See* Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951).

87. *In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 277 (Del. Ch. 2003).

88. *Id.* at 280.

89. *Id.* at 281.

90. *Id.* at 283–84. Under the terms of the non-fault termination clause in Ovitz's employment agreement, he was to receive his salary for the remainder of the contract, discounted at a risk-free rate; $7.5 million bonus for each year remaining on his contract, discounted at a risk-free rate; full vesting of his "A" stock options; and a lump sum termination payment of $10 million. *Id.* at 283.

concerning a material corporate decision."[91] The facts alleged the directors were making "material decisions" regarding an executive compensation package "without adequate information and deliberation," and without care as to whether such decisions injured the shareholders.[92]

After a 37-day trial, the Chancery Court issued a lengthy opinion in favor of the defendants.[93] In considering whether the board breached its fiduciary duties of care, the court applied the business judgment rule, which presumes that the board acted on an informed basis, in good faith and in the honest belief that its action was in the best interest of the corporation.[94] Although the defendants' conduct fell "significantly short" of best practices for corporate governance, the court did not wish to judge the directors' past actions (10 years ago) in light of 21st century "notions of best practice."[95] However, the court outlined the following best practices of corporate governance to guide future boards on the subject of executive compensation and severance payments:

- CEOs should keep boards involved in the process of executive hirings, as opposed to "usurping" such role for themselves;[96]
- CEOs should keep the board informed of all material facts relating to the hiring;[97]
- Boards should be *engaged* in the hiring process of executives and should be willing to think and act for themselves;[98]
- Compensation committees should independently and objectively verify the executive's prior compensation packages and any past troubles with government regulators;[99]

---

91. *Id.* at 289, 291.

92. *Id.*

93. *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005).

94. *Id.* at 747 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). The business judgment rule is used so that courts do not impose themselves unreasonably into the business affairs of corporations. *Id.* at 746 (quoting Cede & Co. Technicolor, Inc., 634 A.2d 345, 360 (Del.1993)).

95. *Id.* at 697.

96. *See id.* at 763 (stating that "Eisner's failure to better involve the board in the process of Ovitz's hiring, usurping that role for himself, although not in violation of law, does not comport with how fiduciaries of Delaware corporations are expected to act.").

97. *See id.* at 761-62.

98. *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 762 (Del. Ch. 2005).

99. *See id.* at 764. The court also affirmed the compensation committee's use of compensation experts. *Id.* at 769.

- The company's lead attorney involved in the negotiation of the executive's compensation should not be the CEO's personal attorney;[100] and
- Press releases regarding the hiring of executives should take place after the board makes its decision, not before.[101]

Upon final appeal, the Delaware Supreme Court held that the shareholders had failed to rebut the business judgment presumption by emphasizing that a breach of duty of care focused more on the quality of the process used in the business decision rather than on the quality of the decision.[102] On the issue of breach of fiduciary duty of good faith, the court stressed that the duty of good faith requires "not simply the duties of care and loyalty . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."[103] Hence, failure to act in good faith could be demonstrated by showing the fiduciary intentionally acted with a purpose other than to promote the interests of the shareholders, the fiduciary acted with the intent to break the law, or the fiduciary consciously disregarded his/her duties.[104] While the court put forth a heightened good faith standard, it concluded that "grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith."[105] The court then affirmed the Chancellor's finding that the Disney directors acted in good faith in approving Ovitz's employment agreement.[106]

Whether Delaware's new good faith standard will shape state corporate governance standards remains to be seen. Its focus on "true faithfulness and devotion to the interests of the corporation and its shareholders"[107] is a welcome sign for shareholders, especially in light of the recent meltdown of high profile corporations.

100. *See id.* at 764-65.
101. *See id.* at 763.
102. *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27, 56 (Del. 2006).
103. *Id.* at 67.
104. *Id.*
105. *Id.* at 65.
106. *Id.* at 67-68.
107. *Id.* at 67.

### C. *I.R.C. § 162(m)—Indirect Attempt to Cap the Amount of Current Compensation*

#### 1. The Purpose of § 162(m)

In 1993, Congress attempted to rein in the *amount* of current executive compensation through the enactment of subsection (m) of I.R.C. § 162.[108] The issue of executive compensation dominated the media in the early 1990s and in particular during the 1992 presidential campaign.[109] The goal of the new legislation was to create a closer tie between compensation and actual performance in order to clamp down on excessive executive compensation. According to a House report, "the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced" by the compensation cap.[110]

I.R.C. § 162(m) indirectly sought to limit the amount of current compensation by imposing a cap of $1 million per year on the deductibility of applicable employee enumeration for "covered employees" at any publicly held corporation where the compensation was not performance-based.[111] As Congress believed that performance-based compensation would increase shareholder value and improve productivity, such compensation was exempt from the new rule.[112] "Covered employees" included a company's chief executive officer and the other four highest paid officers of the company as of the last day of the company's taxable year.[113] "Applicable employee enumeration" included

---

108. *See* The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (codified in scattered sections of the U.S.C.); *see also* Lee E. Sheppard, *Big Paydays Are Back!*, 124 TAX NOTES 99 (2009) (noting that the initial drafting of § 162(m) evolved from a cap on compensation to a cap on the employer deduction as a result of free market ideology).

109. Kenneth R. Ferris & James S. Wallace, I.R.C. Section 162(m) and the Law of Unintended Consequences (Nov. 2006) (unpublished manuscript, on file with the Claremont Graduate University), *available at* http://ssrn.com/abstract=942667.

110. H.R. Rep. No. 103-111, at 646 (1993).

111. I.R.C. § 162(m) (2006).

112. I.R.C. § 162(m)(4)(B).

113. I.R.C. § 162(m)(3); Treas. Reg. § 1.162-27(c)(2) (2009). Treas. Reg. § 1.162-27(c)(2)(ii) states that whether an individual is the chief executive officer or among the four highest compensated officers (other than the chief executive officer) is to be determined in accordance with the SEC executive compensation disclosure rules. Such rules are contained in Item 402 of Regulation S-K. 17 C.F.R. § 229.402 (2008). Such disclosure rules were amended in 2006 to include the principal executive officer (PEO), the principal financial officer (PFO), and the three most highly compensated executive officers other than the PEO and PFO. *See* Executive Compensation and Related Person Disclosure, Securities Act Release No. 33-8732A, Exchange Act Release No. 34-54302A,

cash or property received by covered employees for services performed during the taxable year that would be deductible but for the compensation cap.[114] Commission payments, tax-qualified retirement plan distributions, and nontaxable fringe benefits were excluded from the definition of applicable employee remuneration.[115]

Compensation in excess of the $1 million cap would be deductible only if it was tied to performance.[116] Compensation was considered "performance-based" if the salary was structured so that the covered employee had to attain pre-established, objective performance goals, as designated by a compensation committee of the board of directors. The compensation plan had to satisfy all of the following requirements: (1) compensation was contingent solely on the covered employee's attainment of objective and nondiscretionary performance goals; (2) the method used to determine whether the performance goals were satisfied was based on an objective formula; (3) the performance goals were established by two or more outside directors; (4) the performance goals were disclosed to and approved by the company's shareholders, in a separate vote, prior to payment of the compensation; and (5) prior to paying the compensation, the compensation committee certified that the covered employee satisfied the performance goals.[117]

RMG evaluates equity compensation plans (i.e., performance-based plans) on a case-by-case basis in deciding whether to recommend a withholding vote of any plan.[118] They

---

Investment Company Act Release No. 27444A, 71 Fed. Reg. 53,158 (Sept. 8, 2006). The IRS has ruled that the term "covered employee" for purposes of I.R.C. § 162(m) would not include the "taxpayer's principal financial officer (within the meaning of the amended [SEC] disclosure rules) or an individual acting in such a capacity." I.R.S. Notice 07-49, 2007-25 I.R.B. 1429.

114. *See* I.R.C. § 162(m)(4)(A).

115. I.R.C. § 162(m)(4)(B), (4)(G), (E)(ii).

116. Treas. Reg. § 1.162-27(d) (2009).

117. I.R.C. § 162(m)(4)(C)(i)-(iii). Originally it was believed that an executive compensation arrangement that accelerated distribution on account of events such as death, disability, or change of control before the attainment of the performance goals would not taint the underlying performance-based arrangement. However, the IRS held in Rev. Rul. 08-13, 2008-10 I.R.B. 519 that such acceleration would taint the underlying performance-based arrangement, thereby subjecting any award (regardless of whether the employee terminates or retires) to the $1 million deduction limit. Fortunately, for such arrangements, the effective date of the ruling applies prospectively and there is transitional relief provided. *Id.*

118. *See* VALERIE HO ET AL., RISKMETRICS GROUP, EXPLORATIONS IN EXECUTIVE COMPENSATION: EVALUATING EXECUTIVE PAY COMPONENTS 4 (2008), http://www.riskmetrics.com/sites/default/files/RMGExplorationsPayComponents20080520.pdf; *see, e.g.*, LATHAM & WATKINS LLP, TAX DEP'T: BENEFITS AND COMPENSATION UPDATE,

consider the following factors: whether the total cost to the employer is unreasonable; whether the plan permits re-pricing of stock options or SARs without a prior shareholder vote; whether the CEO is a participant; whether the employer's three-year burn rate (i.e., a synonymous term for negative cash flow) exceeds the greater of 2% or the mean plus one standard deviation of its industry group; whether the plan provides for an acceleration of equity awards apart from a change of control of the employer; and whether the plan results overall in poor pay practices.[119]

2. Unintended Consequences

The enactment of I.R.C. § 162(m) has led to unintended consequences, which ultimately resulted in increasing the average CEO's salary. First, as with its attempt to get rid of golden parachutes, Congress's effort to use the tax code to reduce executive salaries backfired. The congressionally mandated $1 million limit on executive salary became the industry standard. Suddenly all top executives and key employees expected companies to offer a base salary of one million dollars in addition to generous stock options and retirement benefits.[120] The new base salary was expected regardless of industry, effect, company development, or shareholder concerns.[121] The perception existed that boards of directors conceded to the new base salary because the compensation packages were completely deductible.[122]

Second, as performance-based compensation was exempt from the limit, executives were incentivized to become more focused on performance, particularly regarding short-term performance goals as opposed to long term goals.[123] Executives received smaller salaries and a larger performance-based component of compensation.[124] Companies increasingly used

---

FLASH UPDATE: IMPORTANT DEVELOPMENTS ON THE EXECUTIVE COMPENSATION FRONT 1 (2009), http://www.lw.com/ upload/pubContent/_pdf/pub2502_1.pdf.

119. *See generally* HO, *supra* note 118, at 12, 14, 19, 22, 25 (this is not an exhaustive list and discussion of these matters may be found in other portions of the study).

120. *See* John A. Byrne, *That's Some Pay Cap, Bill*, BUSINESSWEEK, Apr. 25, 1994, at 57, *available at* http://www.businessweek.com/archives/1994/b336854.arc.htm.

121. *See id.*

122. *See id.*

123. *See* Sheppard, *supra* note 108 ("Some of the decisions that contributed to this crisis occurred when people were able to earn immediate gains without their compensation reflecting the long-term risks they were taking for their companies and their shareholders.").

124. *See id.* (noting that economist Maria Guadalupe of Columbia Business School explained how the typical executive earned half of his/her compensation as salary before the enactment of I.R.C. § 162(m)).

stock options to supplement executive compensation.[125] Stock options were popular because they were expected to align the interests of executives with those of shareholders by encouraging the executive to manage the company well in order to increase the long-term stock price and his/her compensation.[126]

However, instead of focusing on long-term objectives, executives concentrated on quarterly performance. By meeting Wall Street's performance expectations, the stock price increased at a faster pace, generating more short-term profit for executives upon each stock sale. Unless the stock option program required a vesting period of several years, executives could, and did, exercise their options earlier. In addition, some boards of directors fueled the problem by awarding executives large amounts of option awards, allowing executives to sell stock, re-pricing poor performing stock options in order to prevent executives from leaving, and back dating stock options. The perception was that reliance on the use of options encouraged executives to ignore the long-term effect of current strategy in favor of their short-term financial interests, which increased the risk of dilution for non-employee shareholders.

### 3. Joint Committee on Taxation

In the wake of the Enron scandal, the Congressional Joint Committee on Taxation focused on the various compensation arrangements for executives at Enron.[127] While "Enron had a pay-for-performance compensation philosophy," the Committee discovered that the "compensation costs for all employees, and especially for executives, increased significantly over the years immediately preceding the bankruptcy."[128] "In 2000, total compensation for the [top] 200 highest paid employees [at] Enron [equaled] $1.4 billion . . . $56.6 million [in] bonuses, $1.06 billion attributable to stock options, $131.7 million attributable to restricted stock, and $172.6 million of other income, including base salary," although the company reported $979 million of net earnings.[129] In the short years before 2000, "total compensation

---

125. *See id.* ("Some banks are remunerating their employees with shares . . . .").

126. *See* HO, *supra* note 118, at 7.

127. *See* STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORP. AND RELATED ENTITIES REGARDING FED. TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 36 (Comm. Print 2003), *available at* http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html [hereinafter REPORT OF INVESTIGATION OF ENRON CORP.].

128. *Id.* at 13.

129. *Id.* at 7, 13-14.

for Enron's top executives was $433.6 million."[130] While most of this "qualif[ied] for the exception for performance-based compensation . . . Enron [did pay] a significant amount of nondeductible compensation . . . [i.e.,] $48.5 million [or] 11% of total compensation."[131]

The compensation practice at Enron was criticized by the Joint Committee on Taxation—the compensation committee of the board was simply a "rubber stamp" for management.[132] In addition, the "heavy reliance on stock-based compensation, both [at the executive] . . . and rank-and-file [levels]," exposed the employees to "significant financial loss" when the stock plummeted in value.[133] The Joint Committee concluded that although the $1 million deduction limitation was designed to reduce excessive compensation, it clearly was not achieving its purpose.[134] In the case of Enron and other companies, there was little adverse tax impact with the loss of the deduction.[135] The Joint Committee concluded by recommending that the limitation be repealed and that laws, other than the tax code, be used to address excessive compensation issues.[136]

### D. *I.R.C. §§ 280G and 4999—Indirect Attempt to Limit Change of Control Payments*

#### 1. The Purpose of §§ 280G and 4999

One of Congress's first attempts to use the tax code to regulate the *type* of executive compensation (i.e., increased compensation payable in the event of a corporate takeover, referred to as golden parachute payments) occurred through the Deficit Reduction Act of 1984, as amended by the Tax Reform Act of 1986 (the "Tax Reform Act").[137] During the early 1980s, there was a flurry of mergers and acquisitions of businesses. As many executives resisted or encouraged corporate takeovers based on the potential effect of any takeover on their job security or

130. *Id.* at 42.
131. *Id.*
132. *See id.* at 36.
133. REPORT OF INVESTIGATION OF ENRON CORP., *supra* note 127, at 19.
134. *See id.* at 42.
135. *See id.* at 43.
136. *Id.* at 43.
137. *See* David P. Simonetti, *Applying I.R.C. Section 280G's Golden Parachute Rules*, J. OF DEFERRED COMPENSATION, Winter 2004, at 36 n.2.

financial well being, they simultaneously bargained for special severance arrangements in the event of a change of control.[138]

According to Congress, golden parachutes

> were designed in part to dissuade an interested buyer, by increasing the cost of the acquisition, from attempting to proceed with the acquisition. If the takeover did not occur, the target's executives and other key personnel would more likely retain their positions, so the golden parachute could have had an effect of helping to preserve the jobs of such personnel. Where no takeover had yet commenced but the corporation viewed itself as an unwilling potential target . . . golden parachutes were oftentimes entered into to discourage potential buyers from becoming interested.[139]

In many instances, executives with golden parachute agreements acted to ensure their personal financial success during takeover situations, whether or not the takeover furthered the best interest of shareholders.[140] Congress was concerned that executives with golden parachutes would generally favor takeovers, regardless of the effect on the company, because "they would be handsomely rewarded if an acquisition took place."[141] Golden parachutes swayed their recipients whether paid by the target company or the acquiring company.[142] Ultimately golden parachutes increased the cost associated with each acquisition and reduced the amount payable to shareholders.[143] Congress intervened and used the tax code to discourage such arrangements and change the incentives of executives during merger and acquisition situations.[144]

### 2. Operation of I.R.C. §§ 280G and 4999

I.R.C. §§ 280G and 4999 were enacted simultaneously as part of Congress's broader scheme of deficit reduction.[145] Congress intended to realign executive strategy with that of

---

138. *See id.*

139. STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 199 (Comm. Print 1984).

140. *Id.*

141. *Id.*

142. *Id.* at 199-200.

143. *Id.* at 200.

144. *See id.*

145. Thomas D. Terry, *Golden Parachute Payments (Part 1)*, 24 A.L.I.-A.B.A. BUS. LAW COURSE MATERIALS J. 31, 32 (Oct. 2000).

shareholders by limiting the use of golden parachutes agreements and penalizing such agreements.[146] The money raised by the tax penalties would also be used to help pay off the government's growing deficit.[147]

I.R.C. § 280G limited deductions for payments to executives and key employees when there was a change in control of ownership of the corporation or a substantial portion of the corporation's assets.[148] Payments deemed to be excessive would be nondeductible and subject to an excise tax.[149] Excessive parachute payments ("golden parachute payments") were amounts equal to or in excess of three times the employee's base salary.[150] Employers calculated base salary by considering the employee's average gross income for the five years prior to the tax year at issue.[151]

For purposes of I.R.C. § 280G, parachute payments did not include: (1) payments by corporations whose stock was not publicly traded or by small business corporations[152] if the payment was approved by the corporation's shareholders; (2) payment to or from qualified retirement plans; or (3) payments considered reasonable compensation.[153]

I.R.C. § 280G(b)(2)(C) contains a presumption that payments entered into within one year prior to the change in control are deemed to be contingent upon a change in control.[154]

In addition, Congress imposed tax penalties on companies and employees that were parties to golden parachute agreements. Under § 4999 of the Tax Reform Act of 1984, as amended by the Tax Reform Act of 1986, the new penalty denied a deduction for the excess in change control situations for companies paying parachute payments in excess of limits. It also imposed a 20% excise tax, in addition to regular income and Social Security taxes on benefiting employees.[155] Change of control included changes in company structure, either through stock or ownership, a change in the company's board of directors, or a change in the ownership of a substantial portion of the

---

146. *Id.* at 32-33.
147. *See id.*
148. I.R.C. § 280G (2006).
149. I.R.C. §§ 280G, 4999 (2006).
150. I.R.C. §§ 280G(b), 4999(b) (2006).
151. I.R.C. § 280G(b)(3); Treas. Reg. § 1.280G-1, Q&A (34)-(35) (2003).
152. *See* Treas. Reg. § 1.280G-1, Q&A (6)(b) (However, I.R.C. § 280G does not apply if the entity is or could be a Subchapter S Corporation).
153. I.R.C. § 280G(b)(4), (6).
154. I.R.C. § 280G(b)(2)(C).
155. I.R.C. § 4999(a); *see also* I.R.C. § 280G(b)(2)(A), (C).

assets of the corporation. In addition, employers had to withhold the excise tax where the excess parachute payments were "wages."[156] Congress did not intend that any excess parachute payment made by the acquiring company, or shareholders of the acquired or acquiring company, to "be treated as part of the acquiring company's purchase price for the acquired company, or as increasing the shareholder's basis in his stock in the acquired or acquiring company."[157]

According to RMG, excessive severance or change-of-control pay may result in poor pay practices (leading to a withhold vote) if the plan provides the following: payment of severance or change-of-control payments in excess of the three times base salary limit; payments on termination for cause; payment of change-of-control dollars even though the executive did not lose his/her job or substantial diminution in duties; whether the plan permits the executive to leave voluntarily and nevertheless keep the severance package; or a liberal change-of-control definition that could result in payment without an actual change of control.[158]

### 3. Unintended Consequences

The enactment of I.R.C. §§ 280G and 4999 led to several unintended consequences that increased the spread of golden parachutes in the corporate world.

First, once Congress set a limit on deductibility of parachute payments of three times base pay,[159] that limit became the industry standard. After the new rules were enacted, companies small and large could point to the congressionally sanctioned level as evidence of reasonableness.[160] In addition, companies at risk for takeover became more vulnerable to losing talent. From an executive's perspective, there was less at stake in blocking a take-over attempt if there existed a parachute payment. Thus, they served as an incentive for an executive to leave. As a result, companies had to offer larger compensation packages to compete with growing parachute payments.

Second, some companies softened the impact of the rules through the use of gross-up payments to executives. Grossing up

---

156. I.R.C. § 4999(c)(1).

157. STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 200 (J. Comm. Print 1984).

158. *See generally* HO, *supra* note 118 (explaining Congress's attempt to regulate change control payouts and its impact on current practices).

159. I.R.C. § 280G(a), (b)(2)(A)(ii).

160. Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 963 n.38 (1987).

is a technique used by companies to provide executives the same compensation they would have received *but for* the tax and/or excise tax. A full gross-up would reimburse the executive for the excise tax on the golden parachute payments and the taxes on the gross-up.[161] Gross ups became popular in the 1990s when an increasing component to parachute payments became stock options.[162] Further, companies would adjust the date of options by backdating the option before the stock value increased or postdating the option in expectation of a loss.[163] For 2009, RMG altered its definition of poor pay practices in the context of severance or change-in-control agreements to "include any new or materially amended arrangements that include provisions for the payment of excise tax gross-ups (including modified gross-ups) and/or modified single-triggers (which allow an executive to receive change-in-control severance upon voluntary resignation during a window period following the change in control)."[164]

4. Conclusion

As in the case of the $1 million cap of I.R.C. § 162(m), the use of the tax code to limit the amount of golden parachute payments made to executives has not accomplished its intended goal; in fact, it has exacerbated the situation by causing more employers to inflate parachute packages to levels equal to three times base pay. It has also led to a common practice of tax gross ups to cover the executives' cost for the 20% penalty and income tax on the gross-up for golden parachute payments. Such issues—as to how much to pay for golden parachute amounts and in what contexts such benefits will be paid—may be better off decided by informed compensation committees of the board of directors.

---

161. *See* Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 139-40 (2001).

162. "An option is defined as the right, but not the obligation, to buy or sell a stock." Stock option awards allow "employees the right to buy shares of the company at a set price," or strike price, within a defined span of time. Rick Wayman, *The Controversy Over Option Compensations*, INVESTOPEDIA, http://www.investopedia.com/articles/analyst/091202.asp (last visited Jan. 30, 2010).

163. Glenn Curtis, *A Close-Up On Gross Ups*, INVESTOPEDIA, http://www.investopedia.com/articles/stocks/07/gross-up.asp (last visited Jan. 30, 2010).

164. *See* RISKMETRICS GROUP, U.S. CORPORATE GOVERNANCE POLICY: 2009 UPDATES 25 (2008), http://www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdateUnitedStates.pdf.

### E. *I.R.C. § 409A—Attempts to Limits Deferred Compensation*

#### 1. Rationale for Deferred Compensation

The two most common forms of deferred compensation for executives are equity based awards (e.g., stock options) and nonqualified deferred compensation arrangements. There are legitimate reasons for executives preferring deferred compensation in lieu of current compensation. Those arrangements can be fashioned to benefit the employer as well by conditioning the payment of the deferred compensation upon performance and making it forfeitable under the occurrence of certain events (e.g., working for a competitor). In addition, deferred compensation aligns the executive's interest with that of the future financial health of the employer.

#### 2. Tax Rules

The federal tax rules do not explicitly encourage nonqualified deferred compensation arrangements. Under the Code's matching rules, the employer does not receive a deduction for the compensation deferred by the executive until the executive is taxed on the deferral as income.[165] The executive's deferral is not constructively received if his control over its receipt is subject to a substantial risk of forfeiture.[166] Earnings on such deferrals remain taxable to the employer. Hence, there is no tax incentive for the employer or the employee to deferring compensation, unless the deferral was a benefit or accrual pursuant to a *qualified* pension/profit-sharing plan.[167]

A series of newspaper articles appearing in *The New York Times* in 1996 set off a debate as to whether nonqualified deferred compensation afforded tax loopholes for executives.[168]

---

165. I.R.C. § 404(a)(5) (2006); *see also* Albertson's, Inc. v. Comm'r, 42 F.3d 537, 541 (9th Cir. 1994) (noting that interests on deferred compensation were also subject to the I.R.C. § 404(a)(5) matching rule).

166. Treas. Reg. § 1.451-2(a) (1979).

167. A qualified pension/profit-sharing provides for deferral of income for employees and beneficiaries pursuant to the rules of I.R.C. § 401(a) with an immediate deduction for the employer for contributions made to the qualified trust and delayed taxation to the employees/beneficiaries until actual receipt. Whether the deferral of the deduction for the employer and the deferral of the taxation for the employee under a nonqualified arrangement is totally tax neutral depends upon the respective tax rates for the employer and employee.

168. Christopher Drew & David Cay Johnston, *Rushing Away from Taxes: For the Wealthy, Death is More Certain than Taxes*, N.Y. TIMES, Dec. 22, 1996, at A1; Diana B. Henriques & David Cay Johnston, *Managers Staying Dry as Corporations Sink*, N.Y.

The issue then resurfaced in advent of the Enron bankruptcy when Enron executives began withdrawing monies prematurely from the company's nonqualified deferred compensation plans.[169] As mentioned earlier, this led to a year-long investigation by the Joint Committee on Taxation.[170] It also led to the enactment of I.R.C. § 409A, which imposes an immediate tax and an additional tax equal to 20% of the compensation required to be included in gross income if the terms of the nonqualified plan or its operation fails to satisfy its requirements.[171] An exception exists if the deferred amount continues to be subject to a "substantial risk of forfeiture" or has been previously included in gross income.[172] Failure to comply subjects all deferred amounts, including prior deferrals and notional earnings under the plan with respect to that individual, to current taxation.[173] Hence, unlike I.R.C. § 162(m), which attempts to cap current pay by denying a deduction to the employer, I.R.C. § 409A penalizes the employee (doubly—with current income taxes and a 20% additional tax) if its rules are not satisfied.[174] After years of debate, the final regulations under I.R.C. § 409A were issued on April 17, 2007.[175]

3. New Rules of I.R.C. § 409A

Since the rules of I.R.C. § 409A extend beyond the employer/employee relationship, the regulations use the terms "service recipient" to refer to the entity for whom the services are performed and "service provider" to refer to the individual who

TIMES, Oct. 14, 1996, at A1; Diana B. Henriques & Floyd Norris, *Rushing Away From Taxes: The Capital Gains Bypass,* N.Y. TIMES, Dec. 1, 1996, at A1; Melody Petersen, *Deferred Compensation for the Masses: A Plum at a Price,* N.Y. TIMES, Oct. 27, 1996, at 10. For a more detailed discussion regarding these articles, *see* Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans,* 35 J. MARSHALL L. Rev. 487 (2002).

169. *See* Eric Berger & Mary Flood, *The Fall of Enron: Deferred Payments Under Fire,* HOUS. CHRON., Aug. 17, 2002, at C1, *available at* http://www.chron.com/CDA/archives/archive.mpl?id=2002_3573528 (stating that Enron paid cash compensation through its deferred compensation plans equal to $32 million in October and November 2000 to Enron executives still employed by the company); *see also* REPORT OF INVESTIGATION OF ENRON CORP., *supra* note 127, at 13-14.

170. *See* REPORT OF INVESTIGATION OF ENRON CORP., *supra* note 127, at 1.

171. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified in scattered sections of 26 U.S.C.).

172. I.R.C. § 409A(a)(1)(A)(i) (2006).

173. I.R.C. § 409A(b)(5) (providing that the taxable amount includes interest at the underpayment penalty rate plus 1%).

174. I.R.C. § 409A(a)(1)(B)(i).

175. Application of § 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,278 (Apr. 17, 2007) (to be codified at I.R.C. § 409A). The deadline for full compliance was delayed until December 31, 2008. I.R.S. Notice 07-86, 2007-2 C.B. 990.

performed the services.[176] Nonqualified defined benefit plans are referred to as "nonaccount balance plans," whereas nonqualified defined contribution plans are referred to as "account balance plans."[177] For purposes of the penalty provisions, all nonaccount balance plans for the service provider are aggregated and all account balance plans for the service provider are aggregated.[178] Thus, failure under one nonaccount balance plan subjects all the other nonaccount balance plans covering the individual. Deferrals of the service providers that are not covered by either an account balance or nonaccount balance plan (e.g., severance pay, discounted stock options, stock appreciation rights, and other equity-based compensation) are deemed to be deferred under a separate single plan.[179]

A deferred compensation plan for purposes of I.R.C. § 409A is extremely broad—that is, any plan that "provides for deferral of compensation" other than a qualified pension/profit-sharing plan or any bona fide vacation leave, sick leave, compensation time, disability pay, or death benefit plan.[180] The IRS interprets I.R.C. § 409A to cover a wide range of arrangements, including employment and severance pay agreements;[181] salary continuation and separation pay; deferred bonuses (other than short-time bonuses); discounted stock options, stock appreciation rights, and other equity-based compensation arrangements (i.e., the value of the compensation appreciates over time).[182] Accordingly, the scope of I.R.C. § 409A is very broad and the tax consequences upon the service provider (e.g., executive) are severe if proper compliance is not maintained.

The rules of I.R.C. § 409A impose limitations on the timing of the service provider's election to defer income, including subsequent changes in those elections, and the receipt of the distributions.[183] The election to defer income must generally occur in the tax year prior to the rendering of services relating to

176. *See* Treas. Reg. § 1.409A-1(c)(2)(i)(A)-(C)(2009).

177. *Id.*

178. *Id.* § 1.409A-1(c)(2)(i)(B)-(C).

179. *Id.* § 1.409A-1(c)(2)(i)(D)-(H).

180. Treas. Reg. § 1.409A-1(a)(1),(5) (2007).

181. However, the regulations provide an exception for collectively bargained separation pay arrangements, separation payments that do not exceed two times annual compensation for amounts that do not exceed the annual I.R.C. § 401(a)(17) limit, and certain expense reimbursements. *See* Treas. Reg. § 1.409A-1(b)(9)(ii)-(v).

182. Treas. Reg. § 1.409A-1(b)(5)(D)-(E). There is an exception for restricted stock. *See* I.R.S. Notice 05-1, 2005-1 C.B. 274.

183. I.R.C. § 409A(a)(1)-(4) (2006).

the compensation.[184] For performance-based compensation, the deferral may be delayed as late as six months before the end of the service period (if performance period is at least 12 months in duration).[185] The deferral election has to include the timing of the deferral (e.g., for five years) and the form of distribution (e.g., lump sum or installments). I.R.C. § 409A limits the ability then for the service provider or the service recipient to alter the timing and form of distribution, except for the following situations:

- For distributions in the form of installment payments, a redeferral or subsequent deferral has to be made at least 12 months in advance of the first scheduled payment;[186]
- For distributions made on account of separation of service, a specified time (e.g., 2011) or specified schedule, or change of ownership, a deferral or subsequent deferral must extend the distribution date at least 5 years beyond the original distribution date;[187]
- Any redeferral or change in distribution scheme must not take effect for at least 12 months after the redeferral;[188]
- Acceleration of distributions (e.g., referred to as haircuts) is generally not permitted;[189] and
- Payments made on account of separation of service must be delayed by 6 months for key employees.[190]

The intent of the rules of I.R.C. § 409A is to prohibit manipulation as to the tax year in which the executive incurs income tax on the deferred compensation. Hence, the rules restrict both how the employee defers compensation and when and how the employee can receive that deferral. The ability to accelerate the deferral would be regarded as manipulation and thus prohibited, even if there was a penalty to the employee for such act (e.g., 10% penalty). Thus, the rules are not concerned with the amount of the deferred compensation, as the tax rules of

---

184. I.R.C. § 409A(a)(4)(B)(i). An exception exists for newly eligible individuals where the election may be made within 30 days of eligibility. *See* I.R.C. § 409A(a)(4)(B)(ii).

185. I.R.C. § 409A(a)(4)(B)(iii).

186. I.R.C. § 409A(a)(4)(C)(iii).

187. I.R.C. § 409A(a)(4)(C)(ii).

188. I.R.C. § 409A(a)(4)(C)(i) (2006).

189. I.R.C. § 409A(a)(3); *but see* I.R.S. Notice 05-1, 2005-1 C.B. 274 (providing limited circumstances in which an accelerate distribution may be permitted).

190. I.R.C. § 409A(a)(2)(B)(i).

I.R.C. § 404(a) condition the deductibility of the deferred compensation on the reasonableness of the deferral.

According to RMG, egregious amounts of deferred compensation payments or inclusion of additional years for benefit calculation when the years were not worked which led to large payouts are regarded as poor pay practices that could lead to a withholding vote.[191]

#### 4. Unintended Consequences

The rules of I.R.C. § 409A are driven by well-intended tax policy—avoidance of manipulation of income to defer taxation—but the rules and the IRS's interpretations of the rules are so complex and so burdensome, there is a concern among practitioners that compliance will be too costly and thus, unattainable.[192] If the complexity and burdens drive taxpayers to avoid deferred compensation, we have another unintended consequence—defeating a valid corporate governance policy that promotes aligning the executive's interests with that of the *future* financial health of the employer. However, Congress may choose to expand the breadth and limitations on executive compensation through additional restrictions applicable to deferred executive compensation. It could also expand the penalty tax to apply to the service recipient (e.g., the employer) as well as the service provider in order to deter potential abuse—thereby increasing the cost of providing deferred compensation to executives.

### F. *I.R.C. § 457A—The Most Recent Attempt to Eliminate Deferred Compensation*

Tucked into the TARP legislation was Congress's most recent attempt to further curb executive deferred compensation through the addition of § 457A to the Internal Revenue Code.[193] The original intent was to subject deferred compensation of hedge fund managers, held in offshore tax havens, to taxation upon vesting. However, the final legislative package was written

---

191. *See* HO, *supra* note 118, at 16.

192. The IRS did issue a notice in December 2008 outlining a limited opportunity for plan sponsors of nonqualified deferred compensation arrangements to correct certain operational failures. *See* I.R.S. Notice 08-113, 2008-51 I.R.B. 1305. The IRS has indicated that it does not have the resources to provide determinations, similar to the determination letters issued to qualified retirement plans, in the context of nonqualified deferred compensation arrangements. Rev. Proc. 08-61, 2008-2 C.B. 934.

193. Troubled Asset Relief Program, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (codified in scattered sections of 31 U.S.C.); *see also* I.R.S. Notice 09-8, 2009-4 I.R.B. 34; I.R.S. Notice 08-115, 2008-2 C.B. 1367.

much broader and designed as a revenue enhancer to offset tax extenders that were passed in the legislation.[194]

As noted in the discussion of I.R.C. § 409A, a U.S. employer's deduction for deferred compensation is normally delayed until the executive takes the compensation into income—the so-called "matching" principle. Hence, the employer has no tax incentive to encourage an executive to defer receipt of compensation. A similar check on deferred executive compensation does not exist in the context of a foreign employer, which is tax-indifferent as to immediacy. Thus, in an attempt to subject deferred compensation to immediate taxation upon vesting, Congress added I.R.C. § 457A, which subjects deferred compensation to taxation if it is deferred under a nonqualified plan, generally as defined under I.R.C. § 409A(d), and earned under a nonqualified entity when there is no substantial risk of forfeiture for such compensation.[195] If such amounts are not determinable upon vesting, a 20% excise tax, plus interest, applies.[196] The rules of I.R.C. § 457A apply in addition to the requirements of I.R.C. § 409A. Without getting into the particulars of the legislation, Congress's encroachment into foreign deferred compensation arrangements indicates another example of its distaste for deferred compensation and its willingness to use the tax code as a tool for corporate governance.

### G. *Federal Legislation of Corporate Governance—SOX*

The Security and Exchange Commission administers The Securities Exchange Act of 1934,[197] as well as the earlier Securities Act of 1933.[198] The federal securities laws have generally been regarded as full-disclosure statutes, but the SEC has been interpreting them to regulate corporate governance insofar as it has such authority. In the wake of a growing number of audit failures implicating top accounting firms and the WorldCom and Enron scandals, Congress changed the landscape of corporate governance rules by enacting The Sarbanes-Oxley Act of 2002 ("SOX").[199] According to the SEC Chairman at the

194. I.R.C. § 457A(a) (Supp. 2009). As the TARP legislation provided for a variety of tax extenders, it had to produce revenue measures to offset such extensions. The advent of I.R.C. § 457A was forecasted to produce between $24 to $26 billion in revenue over the scoring period. *Id.*

195. I.R.C. §§ 409A(d), 457A (2006).

196. I.R.C. § 457A(c)(1).

197. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78(d) (2006).

198. *See* Securities Act of 1933, 15 U.S.C. § 77(s) (2006).

199. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 18 U.S.C. §§ 1341, 1343).

time, this legislative initiative represented "the most important securities legislation since the original federal securities laws of the 1930s."[200]

A cornerstone of the new legislation was the establishment of independent audit committees and the responsibilities of audit committees.[201] SOX requires audit committee members to be fully independent with the power to oversee relationships with auditors, communicate with auditors, and determine tenure and compensation of auditors outside of the authority of company managers.[202] Audit committee members are not deemed to be independent, unless exempt by the SEC, if the members "accept any consulting, advisory, or other compensatory fee from the issuer . . . or . . . [are] an affiliated person of the issuer or any subsidiary thereof."[203] Following SOX, the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers Automated Quotations ("NASDAQ") promulgated new rules with stricter standards that enhanced the definition of independent auditor.[204]

The audit committee took on significant leadership in the audit process. The audit committees pre-approve audit and non-audit services. Audit committees receive reports from auditors on critical accounting policies; discuss with management on alternative GAAP, their effects, and the auditor's preference; and have material communications with management. SOX required auditors to report directly to the audit committee. Both managers and auditors are required to disclose any financial weaknesses to audit committees at the risk of criminal

200. William H. Donaldson, Chairman, Sec. and Exch. Comm'n, Remarks to the National Press Club (July 30, 2003), *available at* http://www.sec.gov/news/speech/spch073003whd.htm.

201. *See* Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (requiring the SEC to promulgate new rules for the structure and role of corporate audit committees).

202. *Id.* § 301(m)(2) ("The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.").

203. *Id.* § 301(3).

204. NEW YORK STOCK EXCHANGE, FINAL NYSE CORPORATE GOVERNANCE RULES § 303A (2003), http://www.nyse.com/pdfs/finalcorpgovrules.pdf; NYSE LISTED COMPANY MANUAL § 303A.07 (2009), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F.

penalties.[205] The audit committees are then charged with resolving conflicts between the auditors and management.

Audit committees have the authority to engage financial advisors and special counsel as needed.[206] SOX requires companies to disclose if they have a code of ethics and if any of the audit committee members are "financial experts," a step which provides incentives for firms to adopt codes of ethics and add experts to the audit committees.[207] Furthermore, audit committees are charged with establishing procedures to address employee complaints about audit concerns on a confidential and anonymous basis.[208]

Prior to SOX, the executive's role in the audit process was minimal. SOX now requires the CEO and Chief Financial Officer ("CFO") of an organization to certify and assert to stakeholders that all disclosures were truthful and reliable. The purpose of this mandate is to ensure that the flow of information through the controls of the company is reliable and complete.[209] In addition, the CEO and CFO must certify that the disclosures "fairly present in all material respects" the financial condition and results of the company.[210] The auditor then reports on the reliability of management's assessment of the company's internal controls.[211]

SOX also created the Public Company Accounting Oversight Board ("PCAOB") charged with overseeing public company auditors. The legal mandate of the PCOAB was to "protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports . . . ."[212] The PCAOB's role was to oversee inspection, investigation, and discipline of the auditing function of auditors for public companies.[213] To prevent political influence, the five-member board comprised two experienced auditors and three members that were not members of the accounting profession, each assigned staggered five year terms.[214]

205. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 204, 302, 116 Stat. 745, 773, 777.

206. *Id.* § 301(m)(5).

207. *Id.* § 407.

208. *Id.* § 301(m)(4)(B). Public companies open themselves to civil and criminal liability in companies that retaliate against employees. *Id.* §§ 801-807.

209. *See id.* § 302.

210. *See id.* § 302(a)(3).

211. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 744, 789.

212. *See id.* § 101(a).

213. *Id.* § 101(c).

214. *Id.* § 101(e)(1).

SOX's effectiveness is generally recognized because its effectiveness at achieving its fundamental purpose outweighed its unintended consequences. The new SOX requirements increased the financial burden on publicly traded companies by raising the cost of corporate audits. However, the legislation also changed corporate governance of the auditing process and refocused auditors on auditing. Companies responded by reevaluating their audit committee structure and expanding the oversight responsibilities of audit committees.[215] Auditors no longer held dual roles as auditor and consultant, and refocused on providing higher level auditing services. On balance, SOX's success is attributed to its ability "to get auditors to start being auditors again."[216]

Section 304 of SOX also subjects CEOs and CFOs to clawbacks of certain compensation and stock profits in the event there is a restatement of a *materially* inaccurate financial statement.[217] Such a restatement must be on account of misconduct on the part of the CEO and/or CFO.[218]

Congress may choose to use SOX as the template for similar legislation to curb what it perceives to be excessive executive compensation by imposing similar requirements on the compensation committees of the boards of directors, as it does on the audit committee (e.g., independence of members; new leadership requirements; disclosure of risk assessments; and engagement of independent compensation advisors and special counsel).

### H. *Other Legislative and Regulatory Attempts to Curb Excessive Executive Compensation*

In recent years, there have been numerous attempts to make executive compensation more transparent and accountable. This is consistent with states' corporate governance laws that require boards of directors to make informed and objective decisions regarding *all* their decisions, including executive compensation packages. Other attempts have been made to reform executive compensation tactics including recent revisions to the SEC

---

215. A 2007 study showed that between 2001 and 2004, companies made a substantial commitment to reevaluate the audit committee composition and reassign responsibilities. *See* Hassan R. HassabElnaby, *Audit Committees Oversight Responsibilities Post Sarbanes-Oxley Act*, 22 AM. J. BUS. 19, 20 (2007).

216. Joseph Nocera, *For All Its Costs, Sarbanes Law is Working,* N.Y. TIMES, Dec. 3, 2005, at C1.

217. *See* Sabanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304(a), 116 Stat. 745, 778.

218. *See id.*

disclosure rules and the NYSE rules. The following is a discussion of recent changes to the SEC and NYSE rules.

1. SEC Disclosure Rules

In 2006, the SEC revised disclosure rules in order to shed light on how compensation decisions were made and the particulars of executive compensation packages.[219] The intent of the new rules was to require greater transparency in the compensation decision making process by providing shareholders and boards of directors with clear and comparable information about compensation with which they could make more informed decisions.[220] The disclosure rules affected disclosure of compensation packages in "proxy statements, annual reports, and registration statements."[221] In particular, the new rules made the following important changes to the disclosure rules:

First, the amendments refined the executive and director compensation disclosures. Compensation Discussion and Analysis (the "CD&A") added a narrative component to the disclosure form, which is filed and certified by a company's CEO and CFO.[222] The goal of the CD&A was to provide a comprehensive overview discussing why specific levels of compensation were selected and how the compensation reflects the compensation policies. The new disclosure rules also required the compensation committee report to include a discussion of "whether the compensation committee has reviewed and discussed the [CD&A] with management and, based on this review and discussion, recommended that it be included in"

---

219. *See* Executive Compensation and Related Person Disclosure, *supra* note 113, at 53,158 (explaining that significant changes were made to these rules in December 2006 to conform to the equity compensation disclosure with financial statements reported pursuant to Financial Account Standards Bulletin (FASB)); *see also* 17 C.F.R. § 229.402 (2008). These disclosure rules are intended to impact plan design as the parameters of the plan will be published for public consumption. *See id.* Hence, they are often referred to as "the tail wagging the dog."

220. *Examination of Current Securities Issues, Focusing on Improving Financial Disclosure for Individual Investors: Hearing Before the Comm. on Banking, Housing, and Urban Affairs,* 109th Cong. 40 (2006) (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission) (stating that "the most important parts of total compensation are hidden away in footnotes, scattered in different parts of the proxy statement, or--depending on the form the compensation takes--not even disclosed at all until after the fact").

221. Press Release, U.S. Sec. & Exch. Comm'n, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), *available at* http://www.sec.gov/news/press/2006/2006-123.htm.

222. *Id.* The CD&A was originally designed to provide details regarding the compensation programs for the organization's Chief Executive Officer, Chief Financial Officer, and the three other most highly compensated executive officers. *Id.*

disclosures.[223] In addition, the tabular disclosure was reorganized into three broad categories and the new tables included a column totaling compensation. Equity interests were tabulated showing awards that could be received in the future and "the amount of securities underlying exercisable and unexercisable options, the exercise prices and the expiration dates for each outstanding option."[224]

The new rules lifted the veil on retirement plan benefits. While previously companies disclosed little information about post employment or change-in-control benefits, under the new rules regarding retirement plan benefits, companies are required to summarize the data in a Pension Benefits Table and Nonqualified Deferred Compensation Table. In addition, companies must provide a narrative description of arrangements related to payment or benefits to be paid to named executive officers who are terminated or involved in a change in control.[225]

Second, the new disclosures provided additional guidance regarding disclosure of company programs, plans, and practices relating to stock options. The stock portion table and accompanying narrative include disclosure of the stock option grant date, grant fair market value, the closing price on the grant date and its comparison to the exercise price of the award (if different), and the reasons for the timing of option grants.[226]

Third, the amendments provided new guidance for related person transactions and director independence. For purposes of related person transactions, the amendments increased the dollar threshold for transaction disclosures, required disclosure of related company policies and procedures, and specified exceptions for certain categories of transactions. Disclosure requirements related to director dependence were consolidated and updated to include disclosure of each director or nominee's independence, a description of any transactions not disclosed as related person transactions that were considered by the board of directors during the determination of independence, "any audit, nominating and compensation committee members who are not independent[,] and disclosure of the compensation committee's

---

223. *Id; see also* Sheppard, *supra* note 108 (stating that "SEC-required disclosures of compensation may have contributed to a compensation arms race, leading executives to demand what the other guy has," and attributing this argument to Max Schwartz of Sullivan & Cromwell LLP).

224. Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 221.

225. *Id.*

226. *Id.*

processes and procedures for" determining executive and director compensation.[227]

Fourth, under the new rules companies must disclose the number of shares pledged by management. Fifth, Form 8-K shall include a description of employment agreements and amendments thereto between the company and named executive officers. Sixth, all disclosures must be provided in plain English, easily understandable by any investor or shareholder. Seventh, the new rules added more expansive disclosure requirements specific to registered investment companies and business development companies. Eighth, a compliance section detailed the triggering events and timing of the new disclosure requirements.[228]

While the new rules provided for enhanced transparency requirements, the resulting disclosures were lackluster. Most companies did not expect the new rules would affect the compensation process or quality of corporate disclosures.[229] As a result, the SEC was disappointed with the quality of the resulting disclosures. In 2007, the SEC undertook a review of the 2007 proxy statements of 350 companies and reported on its dissatisfaction with the quality of disclosure reporting.[230] "Far too often, meaningful analysis is missing—this is the biggest shortcoming of the first-year disclosures."[231]

On July 17, 2009, the SEC proposed changes to its proxy disclosures rules with comments due back by mid-September.[232]

227. *Id.*

228. *Id.*

229. A January 2007 study showed that 70% of companies thought the 2006 requirements would have a "minor at best" impact on company compensation programs. Mercer Human Resource Consulting, *The SEC Executive Compensation Disclosure Rules: Final Thoughts and A Look Ahead,* Jan. 16, 2007, *available at* http://www.mercer.com/attachment.dyn?idContent=1255430&filePath=/attachments/English/SEC_Executive_Compensation_Final_Rules_1-16-07_Web_Cast_final.pdf. Regarding the changes being made or considered as a result of the new disclosure requirements, only 28% of companies were "considering or [had] made changes" to equity grant practices and 5% were "considering or [had] made changes" to their performance measures. *Id.*

230. Press Release, U.S. Sec. & Exch. Comm'n, Commission Staff Publishes Its Observations in the Review of Executive Compensation Disclosure (Oct. 9, 2007), *available at* http://www.sec.gov/news/press/2007/2007-214.htm.

231. John W. White, Director, Div. of Corp. Fin. SEC, Address at Tackling Your 2008 Compensation Disclosures: The 2nd Annual Proxy Disclosure Conference (Oct. 9, 2007).

232. U.S. Securities and Exchange Commission, *Proxy Disclosure and Solicitation Enhancements*, Rel. Nos. 74 Fed. Reg. 35,076 (proposed July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270 and 274). According to SEC Chairman Mary Schapiro, "The Commission will be considering whether greater disclosure is needed about how a company—and the company's board in particular—manages risks, both generally and in the context of setting compensation. I do not anticipate that we will see to mandate any particular form of oversight; not only is this really beyond the Commission's traditional

The proposal went beyond a description of the principles behind the company's executive compensation packages by expanding the CD&A to ascertain whether the company's compensation arrangements (beyond that of the CEO, CFO and top three NEOs) created incentives affecting the company's risk and management of that risk.[233]

Due to what the public has seen in the financial markets, the SEC wants corporations to disclose whether the compensation committee examined the compensation arrangements to see if any aspects encouraged unnecessary and excessive risk.[234] It also wants to see if the compensation committee looked at aspects of the broad compensation programs available to all employees to ascertain whether there were elements that could potentially impose undue risk on the employer's business.[235] If finalized in their current form, the new rules would require disclosure as to whether the compensation committee examined the compensation programs for risk, determined that such programs were within tolerable limits, or corrected such programs to bring them within such limits, and then continued to manage ongoing risks (e.g., by imposing caps on incentive pay, stock holding rules, clawbacks, and coordination of short and long-term goals).[236]

The SEC proposed rules also would insert four new governance requirements:

- In the context of a compensation consultant operating under a conflict of interest,[237] the following disclosure

---

disclosure role, but it would suggest that there is a one-size-fits-all approach to risk management. Instead, I have asked our staff to develop a proposal for Commission consideration that looks to providing investors, and the market, with better insight into how each company and each board addresses these vital tasks." *See* Mary L. Schapiro, SEC Chairman, Address to the Council of Institutional Investors (Apr. 6, 2009), *available at* http://www.sec.gov/news/speech/2009/spch040609mls.htm. The SEC proposal also would require the full grant date fair value of stock and options to be reported in the year of the grant. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,079.

233. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 135,077-78 (July 17, 2009) (to be codified at 17 C.F.R. pt. 229, 239, 240, 249, 270, and 274).

234. *See id.* at 35,105.

235. *Id.* at 35,015-16 (requiring disclosure of "material information concerning how the registrant compensates and incentivizes its employees that may create risk"). In ascertaining whether compensation practices encourage material risk for the employer, the SEC may look to various "business unit[s within] the company that carr[y] significant portion[s] of [its] risk profile"; whether compensation structures vary within business units; whether some units are more profitable than others; compensation expense for a given unit relative to its revenues; and, whether the unit's compensation structure "var[ies] significantly from the overall risk and reward structure of the [employer]." *Id.*

236. *See id.*

237. Such conflicts of interest could exist in the case of a compensation consultant providing other services to the company, such as benefits administration, human resource

would be required: the level of additional services provided by the consultant; the fees paid for such services; management's involvement in the selection of the consultant for these other services; and whether the board or compensation committees approved of the use of the consultant for these other services.[238]

- Disclosure regarding the particular qualifications, experience and skills of an individual to be nominated as a director so that shareholders can determine whether such individual would be a good fit;[239]
- Disclosure as to the corporation's leadership structure (e.g., whether the CEO and the chairman of the board are one and the same person so that the shareholders can ascertain whether there is too much control in a single person);[240] and
- Disclosure regarding the board's role in the corporation risk analysis, both in general and with respect to compensation.[241]

According to SEC Chairman Mary L. Schapiro, recent changes were designed to provide shareholders with information regarding the corporation policies and procedures surrounding compensation packages and incentive arrangements.[242] Such policies were also to promote transparency surrounding the business' risk management, both in general and with respect to compensation.

### 2. NYSE Rules

On July 1, 2009, the SEC also approved proposed changes to the NYSE Rule 452 and § 402.08 of the NYSE Listed Company

---

consulting, or actuarial services. Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,079 (July 17, 2009) (to be codified at 17 C.F.R. pt. 229, 239, 240, 249, 270, and 274).

238. *Id.* at 35,108.

239. *Id.* at 35,105.

240. *Id.* at 35,108.

241. *See id.* at 35,076-78, 35,108.

242. *See* Press Release, U.S. Sec. & Exch. Comm'n, Chairman Schapiro Statement on Executive Compensation (June 10, 2009), *available at* http://www.sec.gov/news/press/2009/2009-133.htm. ("[T]he SEC is actively considering a package of new proxy disclosure rules that will provide further sunshine on compensation decisions. While these proposals would not dictate particular compensation decisions, they would lead companies to analyze how compensation impacts risk taking and the implications for long term corporate health of the behavior they are incenting.").

Manual limiting the use of proxies.[243] The old NYSE Rule 452 provided that within ten days prior to a vote, a NYSE member company could elect a proxy to vote on the company's behalf, without voting instructions from shareholders.[244] The proxy power extended to all matters not specifically excluded by Rule 452 as "non-routine" matters.[245] The rule prevented proxies from voting without instructions from shareholders on non-routine matter that would substantially affect the rights and privileges of shareholders.[246] As a result, shareholders had limited power to express their disapproval of directors and key board actions.

The amended Rule 452 reforms the proxy rule by extending the definition of non-routine matters to include election of company directors.[247] Once the new rule goes into effect, proxies can only cast votes for directors when instructed by shareholders rather than proxies assuming that shareholders will vote in line with management. Critics argue that the new rule will hinder the ability of issuers to obtain sufficient votes for director votes. Once brokers lose the ability to cast votes for uninstructed shares, it is likely that fewer votes will be cast in uncontested elections, and directors may not receive the number of votes necessary for reelection. In order to achieve a quorum, issuers will need to take a more active role in soliciting votes.

### I. *Recent Legislative/Regulatory Attempts for TARP Recipients—Possible Templates for Future Initiatives*

#### 1. Presidential Campaigning

During summer and early fall of 2008, both presidential candidates addressed the issue of executive compensation while on the campaign trail—mainly addressing the issue of shareholder say-on-pay vote for public companies. According to the then Senator Barack Obama:

---

243. Order Approving Proposed Rule Change, as Modified by Amendment No. 4, To Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 To Eliminate Broker Discretionary Voting for the Election of Directors, Exchange Act Release No. 34-60215, 74 Fed. Reg. 33,293 (July 1, 2009).

244. *Id.* at 33,294.

245. *Id.* at n.14.

246. *Id.* at 33,294. NYSE Rule 452.11 sets forth the full list of matters on which NYSE member organizations may not vote without customer instructions. *Id.* at n.14.

247. *Id.* at 33,293; NYSE Rule 452.11(19) (2003), *available at* http://nyserules.nyse.com/NYSETools/bookmark.asp?id=sxpolicymanualnysePROXIESR450460&manual=/nyse/rules/nyse-rules/.

> [W]hat we need to do is restore balance to our economy and put in place rules of the road to make competition fair, and open, and honest. One place we can start is by restoring common sense to executive pay. That's why last year, I proposed legislation that would give shareholders a say on what CEOs are getting paid, and help ensure that companies are disclosing the rationale for the salary and benefits that CEOs are getting. This isn't just about expressing outrage. It's about changing a system where bad behavior is rewarded—so that we can hold CEOs accountable, and make sure they're acting in a way that's good for their company, good for our economy, and good for America, not just good for themselves.[248]

Senator McCain likewise called for a say-on-pay vote for public companies, requiring that "all aspects of a CEO's pay, including any severance agreements, must be approved by shareholders."[249] He also criticized golden parachutes and excessive compensation arrangements paid by companies receiving public funds.[250] According to McCain, "[t]he senior executives of any firm that is bailed out by Treasury should not be making more than the highest paid government official."[251]

2. Initial TARP Legislation for Certain Financial Institutions

Such campaign rhetoric set the stage for regulation of companies that would receive public aid through the Capital Purchase Program ("CPP") created under TARP, which was established by the Emergency Economic Stabilization Act of 2008 ("EESA").[252] Originally there were nine banks (Citigroup,

---

248. Senator Barack Obama, Remarks on Executive Compensation at Press Conference in Indianapolis (Apr. 11, 2008), *available at* http://my.barackobama.com/page/community/post/jessicaslider/gGBWc9.

249. Avi Salzman, *McCain Seeks Shareholders' Say on Pay,* BUSINESSWEEK, June 10, 2008, http://www.businessweek.com/bwdaily/dnflash/content/jun2008/db20080610_480485.htm.

250. Dawn Kopecki & James Rowley, *Dodd Proposes Giving U.S. Equity Stake for Bad Debt*, BLOOMBERG, Sept. 22, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aHeROL9EmlRg#.

251. *Id.*

252. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified in scattered sections of 5, 12, 15, 26 and 31 U.S.C.); *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys., Agencies Encourage Participation in Treasury's Capital Purchase Program, FDIC's Temporary Liquidity Guarantee Program (Oct. 20, 2008), *available at* http://www.federalreserve.gov/newsevents/press/

JPMorgan, Wells Fargo, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bank of America, Bank of New York Mellon, and State Street Bank) that were required to participate in TARP. As participants in the CPP, the compensation for executives of these nine banks became subject to three restrictions: (1) additional limits on current pay,[253] (2) additional limits on severance pay,[254] and (3) appropriate standards for executive compensation and corporate governance.[255]

a. Additional Limits on Current Compensation

As an indirect attempt to restrict current compensation, EESA lowered the employer's maximum tax deduction cap under I.R.C. § 162(m) from $1 million to $500,000 for any senior executive officer ("SEO") for any year in which the employer participated in the CPP.[256] It also eliminated the I.R.C. § 162(m)(4) exclusion of both commissions and "[o]ther performance-based compensation" from the remuneration that is subject to the deduction cap.[257] When considered together, the effect of this restriction is to subject a greater amount of the compensation paid to an affected executive to a reduced deduction limitation.

In addition to limiting the amount of deduction for each affected executive, EESA provides for a potentially larger group of covered executives. Whereas I.R.C. § 162(m) includes in the definition of "covered executive" the individual serving as the CEO on the last day of the applicable year,[258] the new rules cover

---

bcreg/20081020a.htm. EESA granted the Secretary of the Treasury the authority to restore the financial markets and "to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary." Emergency Economic Stabilization Act of 2008 § 101(a). Section 111 of EESA imposed corporate governance and executive compensation standards upon TARP recipients until February 17, 2009, when it was modified and replaced by the enactment of § 7001 of the American Recovery and Reinvestment Act of 2009 (ARRA), which provided new executive compensation standards and required the Treasury to promulgate regulations to implement section 111 of EESA. *Id.* § 111; *see also infra* note 285.

253. *See* Emergency Economic Stabilization Act of 2008 § 302(a) (amending I.R.C. § 162(m) (2006 & Supp. 2009)).

254. *See id.* § 302(b) (amending I.R.C. § 280G (2006 & Supp. 2009)).

255. *See id.* § 111(b)(1).

256. *See id.* § 302(a) (defining the Special Rule For Application to Employers Participating in the Troubled Assets Relief Program).

257. The lack of an exception for performance-based compensation under EESA may indicate that Congress is also suspicious of this type of compensation as the measures for performance can be easily met. *See id.* (amending I.R.C. § 162(m)).

258. I.R.C. § 162(m)(3)(A).

any and all individuals who serve as the CEO or the CFO during the taxable year at issue.[259]

Further, once a CEO, CFO, or other executive is identified as a "covered executive" for any applicable year, said individual is deemed to be a "covered executive" in all subsequent tax years regardless of whether the executive satisfies the specific definition of "covered executive" in those future years.[260] In summary, these EESA provisions serve to limit the employer's deduction on compensation paid to an expanded number of executives.

b. Additional Limits on Severance Compensation

EESA limits the *amount* of any golden parachute payment (not simply a limit on the employer's deduction) by prohibiting the payment of any golden parachute payment to a SEO or any of the next five most highly-compensated employees during the TARP period.[261] Treasury issued regulations (referred to as the Interim Final Rules) in June of 2009, wrapped up all prior and new guidance in a single package.[262] The Interim Final Rule made it clear that EESA limits the prohibition to those payments made in connection with a change in control (i.e., golden parachute payments), not all severance arrangements.[263] As a golden parachute payment is any compensation that exceeds three times the recipient's "base amount," this rule effectively limits the amount of any payments made on account of involuntary termination or termination as a result of bankruptcy to three times the recipient's "base amount" as defined by I.R.C. § 280G.[264]

First, EESA expands the scope of the term "parachute payment" to include any payment for departure made to an

259. I.R.C. § 162(m)(5)(D)(i)(I).

260. I.R.C. § 162(m)(5)(D)(i)-(iii).

261. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(b)(2)-(3), 122 Stat. 3765, 3776-77 (codified in scattered sections of 5, 12, 15, 26, & 31 U.S.C.).

262. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30). The Interim Final Rule "revises in its entirety 31 CFR Part 30, which comprises Treasury's regulations implementing section 111 of EESA." *Id.* at 28,396.

263. 31 C.F.R. § 30.1, Q&A (1) (2009).

264. A parachute payment is defined as any payment in the nature of compensation that was/is "contingent on a change in the ownership or effective control of the employer, or in the ownership of substantial assets of the corporation, the aggregate present value of [which] exceeds" three times the recipient's "base amount." I.R.C. § 280G(b)(2)(A) (2006). The "base amount" equals the recipient's annualized includible compensation averaged over the five calendar years prior to the year in which the change of control occurs. I.R.C. § 280G(b)(3).

employee (1) by reason of involuntary termination or (2) in connection with the employer's bankruptcy, liquidation, or receivership.[265] Previously, payments were included only upon a change in ownership or effective control, or upon a change in ownership of a substantial portion of assets.[266] The Interim Final Rule excludes from the definition of golden parachute payments qualified retirement plans and similar foreign retirement plans, payments due to an employee's death or disability, and severance payments.[267]

Additionally, EESA expands the scope of the term "parachute payment" through the elimination of several key exclusions. For example, the presumption that agreements entered into within one year of a change of control are held to be made upon a change in control may no longer be rebutted under the EESA modifications.[268] Similarly, I.R.C. § 280G's exclusion from parachute treatment any payments that the employer establishes as reasonable compensation or payments made by a "small business," is no longer permitted under the EESA modifications.[269]

A golden parachute payment is treated as paid at the time of the employee's departure, regardless of when the amounts are paid, so that the restriction may not be avoided by making payments to the employee after the TARP period has ended.[270]

c. Appropriate Standards for Executive Compensation and Corporate Governance

The third prong of the EESA restrictions provides new prohibitions on executive compensation without regard to employer deductibility. Instead, EESA § 111 focuses on the operating provisions of compensation arrangements for SEOs (defined as the top five highly paid SEOs whose compensation is subject to disclosure under the SEC proxy rules).[271] The compensation committee of the employer's board of directors is now required to review SEO incentive compensation

265. Emergency Economic Stabilization Act of 2008 § 111(b)(2)-(3) (prohibiting any golden parachute to a SEO during the period in which the Treasury holds an equity or debt position in the employer).

266. *See* I.R.C. § 280G(b)(2)(A)(i).

267. 31 C.F.R. § 30.1, Q&A (1) (2009).

268. I.R.C. § 280G(b)(2)(C), (e)(1)(D).

269. *Id.*

270. TARP Standards for Compensation and Corporate Governance, *supra* note 262, at 28,399.

271. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(b)(3), 122 Stat. 3765, 3777 (codified in scattered sections of 5, 12, 15, 26, and 31 U.S.C.).

arrangements to ensure that they do not encourage excessive risk-taking and, if they do, affirm that the committee has made appropriate revisions.[272] The Committee must also certify its review in the proxy's CD&A.[273] SEO incentive compensation arrangements must provide for the recovery of bonuses or awards paid pursuant to "statements of earnings, gains, or other criteria" that later prove to be "materially inaccurate" (i.e., referred to as clawback provisions).[274] Covered employers are prohibited from making golden parachute payments to the top five highest paid executives under existing arrangements,[275] and prohibited from entering into new employment contracts with these executives that provide "a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership."[276] Clearly, these provisions represent a new direction as Congress is dictating the terms of the executive compensation agreements, not simply limiting the amount of the employer's deduction.

### 3. Events in 2009 Leading to the Passage of ARRA

In January of 2009, Merrill Lynch (one of the initial TARP recipients) accelerated bonus payments just prior to its sale to Bank of America ("BoA")—at the very time Merrill Lynch's losses were increasing and Ken Lewis, chief executive to BoA, was asking for additional TARP funds.[277] This prompted New York Attorney General Andrew Cuomo to send a letter to the nine

---

272. *Id.* § 111(b)(2)(A). The legislation does not define what is meant by "risk" or what constitutes "excessive risk." Generally one thinks of risk as the expected harm that could occur in pursuit of a given objective, a so-called balancing of rewards against losses. The EESA does not prohibit using risk as a factor in ascertaining compensation, but does prohibit excessive risk-taking. *See* Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1131 (2007) (describing "risk-and-rewards" approach as an "estimation of expected losses and returns" in a general business context).

273. Emergency Economic Stabilization Act of 2008 § 111(b)(2)(B) (requiring "the recovery . . . of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate").

274. *Id.*

275. *Id.* § 111(c).

276. *Id.*

277. Rick Newman, *More Outrage Over the Merrill Bonuses*, U.S. NEWS AND WORLD REPORT (Mar. 12, 2009), *available at* http://www.usnews.com/blogs/flowchart/2009/03/12/more-outrage-over-the-merrill-bonuses.html (stating that the payment of bonuses to Merrill Lynch executives was "a crystallizing episode in the Great Financial Meltdown. To most Americans, it's absurd for a company that lost nearly $28 billion in 2008, nearly collapsed, and survived thanks only to a taxpayer-subsidized rescue, to lavish million-dollar bonuses on dozens of executives . . . This can only end badly for Merrill and BofA, with repercussions that could ricochet throughout Wall Street and dramatically change established practices.").

original TARP banks asking for information about their expected bonus payments for the year prior to first receiving TARP funds and the year after receiving such funds.[278] Similarly, Representative Henry Waxman (D-Cal.) announced his intent to launch an investigation regarding the bonus payments expected to be paid to the executives of the nine banks, as did Representative Dennis Kucinich (D-Ohio).[279]

Then on February 4, 2009, President Obama and the Treasury Department issued a press release outlining new and tougher restrictions on executive compensation programs for financial institutions receiving public funds through the TARP program.[280] The restrictions varied depending on whether the institution was receiving "exceptional help" (e.g., bank-specific negotiated agreements with AIG, BoA, and Citigroup) versus those receiving funds from the "generally available" program.[281] They imposed a $500,000 limit on the amount of annual compensation that could be paid to SEOs (with the exception for certain long-term incentive compensation), and added "say-on-pay" requirements as well as luxury expenditure policies.[282]

#### 4. ARRA '09

All of these events made it easy for Congress to amend the executive compensation provisions of EESA with the passage of the American Recovery and Reinvestment Act ("ARRA")[283] on February 17, 2009. While Congress chose not to further modify the additional restrictions on current compensation and severance pay, it did determine that substantial changes to

---

278. Letter from Andrew M. Cuomo, Attorney General, State of New York Office of the Attorney General, to Citigroup, Inc. Bd. of Directors (Oct. 29, 2008), *available at* http://www.oag.state.ny.us/media_center/2008/oct/citigroup.pdf. ("[N]ow that the American taxpayer has provided substantial funds to your firm, the preservation of those funds is a vital obligation of your company. Taxpayers are, in many ways, now like shareholders of your company, and your firm has a responsibility to them. Accordingly, we also ask that the Board inform us of the policies, procedures, and protections the Board has instituted that will ensure Board review of all such company expenditures going forward. Please provide this Office with an accounting of the actions the Board plans to take that will protect taxpayer funds.").

279. *Chairman Waxman Requests Compensation and Bonus Information for Employees at Major Banks*, OVERSIGHT.HOUSE.GOV, Apr. 29, 2009, http://oversight.house.gov/index.php?option=com_content&view=article&id=3472:chairman-waxman-requests-compensation-and-bonus-information-for-employees-of-major-banks-&catid=43:investigations.

280. Posting of Macon Phillips to The White House Blog, http://www.whitehouse.gov/blog_post/new_rules (Feb. 4, 2009, 14:51 EST).

281. *See id.*

282. *Id.*

283. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (codified in scattered sections of the U.S.C.).

EESA § 111 were required. Thus, § 111 was subsequently rewritten to expand the scope of areas previously covered and to include additional standards for executive compensation and corporate governance. While these new limitations apply only to companies accepting TARP funds (including financial and nonfinancial institutions), executives of most publicly held companies are following the legislation closely in the event they serve as the Administration's and Congress's template for future legislation to be applied to *all* employers, or at least public companies. The legislation limits the amount of incentive compensation that may be paid and imposes tougher limitations on golden parachute payments.[284]

a. Severance Provisions

ARRA expands the prohibition against change-in-control payments to include any severance and/or change-in-control payments, regardless of whether the payment is on account of termination of employment for any reason or change in control.[285] Such prohibition applies to the SEOs and any of the next five most highly-compensated employees and is effective for preexisting employment contracts.[286]

b. Clawback Provisions

ARRA expands the scope of the original provisions of EESA regarding clawbacks to recover not only from the SEOs, but also from the next twenty most highly compensated employees, as well.[287] Note that while the occurrence of a "material inaccuracy" depends on the facts and circumstances, the Interim Final Rules make is clear that a financial statement or metric will be treated as materially inaccurate with respect to any employee who knowingly provided inaccurate statements or metrics, or failed to timely correct known inaccurate statements or metrics.[288] Under the Interim Rules, clawbacks must be reinforced upon a triggering event unless the TARP institution can demonstrate that it would be unreasonable to do so (e.g., expense of administration exceeds the benefits of enforcement).[289]

c. Prohibition on Bonuses, Retention Awards and

284. *Id.* sec. 7001, § 111(b)(3) (amending 12 U.S.C. § 5221(b)(3) (2006)).
285. *Id.* sec. 7001, § 111(a)(2) (amending 12 U.S.C. § 5221(a)(2)).
286. *Id.* sec. 7001, § 111(a)(1) (amending 12 U.S.C. § 5221(a)(1)).
287. *Id.* sec. 7001, § 111(b)(3)(B) (amending 12 U.S.C. § 5221(b)(3)(B)).
288. 31 C.F.R. § 30.8, Q&A (8) (2009).
289. *Id.*

Incentive Compensation

A new restriction added by ARRA is the prohibition of "paying or accruing any bonus, retention award, or incentive compensation" for certain SEOs while the employer is receiving TARP benefits.[290] However, Congress expressly approved of the use of long-term restricted stock, provided that the stock does not vest while the employer is still receiving TARP funds and that the award is limited to one-third of the recipient's annual compensation.[291] The number of SEOs considered for this purpose depends on how much public funds the recipient institution is receiving; but the individuals considered are determined by their compensation, not by whether they are an executive officer.[292] For example, were the employer receiving the lowest level of TARP support, only the employer's single most highly paid employee would be subject to this new prohibition, whereas an employer receiving the highest level of TARP support would apply this new prohibition to the SEOs and "*at least* the 20 next most highly-compensated employees[.]"[293]

Under the Interim Final Rule, the Treasury may review bonuses, retention awards, and other compensation paid to SEOs and the next 20 highest paid employees prior to ARRA's enactment to see if such payments were inconsistent with TARP or contrary to public interest.[294]

d. Luxury Expenditures

ARRA requires that each TARP recipient establish a company-wide policy prescribing guidelines for excessive or luxury expenditures.[295] Such expenses include, but are not limited to: "entertainment or events; office and facility renovations; and aviation or other transportation services; or other activities or events" to the extent that those expenditures "are not reasonable for staff development, performance incentives, or other measures in the usual and normal course of business . . . ."[296] The Interim Final Rules mandate that the

---

290. American Recovery and Reinvestment Act of 2009 sec. 7001, § 111(b)(3)(D)(i).

291. *Id.* sec. 7001, § 111(b)(3)(D)(i)(I)-(III). The bonus exception for long term restricted stock is contingent on the following: the stock does not vest until public funds are repaid; the value of restricted stock does not exceed one-third the executive's annual compensation; and the stock is subject to other "terms and conditions" that the Treasury deems to be in the public's interest. *Id.*

292. *Id.* sec. 7001, § 111(b)(3)(D)(i)(I)-(IV).

293. *Id.* sec. 7001, § 111(b)(3)(D)(i)(I), (IV) (emphasis added).

294. 31 C.F.R. § 30.8 (2009).

295. American Recovery and Reinvestment Act of 2009 sec. 7001, § 111(d).

296. *Id.* sec. 7001, § 111(d)(1)-(4).

board of directors of each TARP recipient determine what are excessive and luxury expenditures and establish a written set of requirements that are specific to the TARP recipient.[297] This company-wide policy must include the following standards:

- Identification of the types or categories of expenditures that are prohibited;
- Identification of the types or categories of expenditures for which approval is required;
- Approval standards by which expenditures needing review may be approved;
- PEO and PFO certification that the approval of any expenditure requiring the approval of a senior executive or officer or board of directors was properly obtained;
- Prompt internal reporting of policy violations; and,
- Accountability for adherence for these policies.[298]

A copy of the policy must be submitted to the Treasury and the employer must post a copy on its internet website if it maintains such a site.[299] Finally, the TARP recipient is under a duty to maintain this policy. In the event a modification is required, the TARP recipient must, within ninety days from the date of modification, submit the revised policy to the Treasury and, if applicable, post the revised policy on its internet website.[300]

Under the Interim Final Rules, additional disclosure of perks is required for the type and amount of perquisite extended to any employee (subject to the Act's bonus restriction) with a total value exceeding $25,000.[301] It also contains a prohibition on tax gross-ups on golden parachutes and perquisites for "SEOs and the next twenty most highly compensated employees during the TARP period."[302]

According to RMG, excessive perks such as personal use of corporate aircraft, tax gross-ups, and perks for former executives are all regarded as poor pay practices that could lead to a recommended withholding vote.[303]

297. 31 C.F.R. § 30.12 (2009).

298. 31 C.F.R. § 30.1, Q&A (1) (2009).

299. 31 C.F.R. § 30.12, Q&A (12) (2009).

300. *Id.*

301. 31 C.F.R. § 30.11, Q&A (11)(b)(1) (2009).

302. *Id.* at Q&A (11)(d).

303. HO, *supra* note 118, at 12, 14.

#### e. The Board's Compensation Committee

ARRA requires the compensation committee (comprised of independent directors) of the board of directors to conduct a semiannual review of the existing and proposed executive compensation arrangements to "discuss and evaluate" and to assess any risk posed to the employer by such arrangements.[304] The Interim Final Rules expand this duty, providing for several categories of semiannual review, committee certification of the completion of these reviews, and an annual narrative describing how the compensation arrangements do not reward excessive risk.[305] While the rules do not define what constitutes excessive risk, the focus appears to be on whether compensation focused on short-term results in lieu of long-term value added to the corporation.

The committee's certification is required to be filed with the Treasury and, if the employer is a publicly traded company, it must also be included in the CD&A report.[306] It is not clear why the Treasury added this requirement, as ARRA requires the CEO and CFO to file a similar certification. Regardless, it is clear that certification is regarded as an invaluable tool to monitor and constrain executive compensation.

Under the Interim Rule, mandated disclosure of consultants to the compensation committee is now required, including a description of *all* services (including non-compensation related services) provided by the compensation consultant to the institution or its affiliates (during the last three years), and the "benchmarking" procedures used by the consultant to measure executive compensation.[307]

#### f. Say-On-Pay

ARRA requires a shareholder say-on-pay vote on the compensation of executives in the annual proxy statement of the TARP recipient.[308] The vote is non-binding on the board of directors and does not result in the imposition of any additional

---

304. American Recovery & Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 7001, § 111(c)(2), 123 Stat. 115, 519.

305. *See* 31 C.F.R. § 30.15 app. A, B (2009).

306. 31 C.F.R. § 30.15, Q&A (15)(a)(4)-(5) (2009).

307. 31 C.F.R. § 30.11, Q&A (11)(c)(1) (2009). The assumption is that compensation consultants relying on executives for hiring them to perform other services for the corporation are conflicted and thus "rig the system" to inflate the compensation packages for such executives. *See* Martin A. Sullivan, *Will Congress Extend Tax Limits on Pay to All Firms?*, 124 TAX NOTES 1169 (2009).

308. *See* American Recovery & Reinvestment Act of 2009, sec. 7001, § 111(e), 123 Stat. 115, 519-20.

fiduciary duty on the board.[309] On July 1, 2009, the SEC proposed rules for TARP recipients, implementing the rules under ARRA that call for a say-on-pay vote on "the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the Commission."[310]

#### g. The Office of the Special Master for TARP Executive Compensation

As mentioned earlier, ARRA instructs the Secretary of the Treasury to review the bonuses, retention awards, and other compensation paid to certain employees prior to February 17, 2009. This group of affected employees included the SEOs and the next twenty most highly paid employees of the TARP recipient. The purpose of the review was "to determine whether any such payments were inconsistent with the purposes of . . . the TARP or were otherwise contrary to the public interest."[311]

One of the most notable rules contained within the Interim Final Rules was the appointment of a "Special Master" to review the compensation arrangements and the corporate governance practices of the seven institutions receiving "exceptional

309. *See* TARP Standards for Compensation and Corporate Governance, *supra* note 262, at 28,397.

310. *See* U.S. Securities and Exchange Commission, *Shareholder Approval of Executive Compensation of TARP Recipients*, Rel. No. 34-60218, 74 Fed. Reg. 32,474 (July 8, 2009). The purpose of the "say-on-pay" rule is to create "better, more timely disclosure," and discourage compensation schemes that "encourage executives to take excessive risks." Daniel Wagner, *SEC Requires All Companies To Provide More Info On Exec Pay*, USA TODAY, July 2, 2009, *available at* http://www.usatoday.com/money/companies/management/2009-07-01-sec-exec-pay_N.htm?csp=34&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+UsatodaycomMoney-TopStories+(Money+-+Top+Stories); *ERP #79: Top 10 Tips For Improving CD&A Disclosure*, MERCER, Feb. 11, 2009, *available at* http://www.mercer.com/referencecontent.htm?idContent=1335990. The proposal states that no specific language or form is required in the proxy for the say-on-pay vote, clarifies that such proxy must be filed in preliminary form with the SEC, and is silent on how to count such shareholder votes. While this proposal is applicable only to TARP recipients, it will be of interest to other publicly held entities. According to the RiskMetrics Group, the following key questions should be asked in any say-on-pay analysis: "Does the company demonstrate a strong link between executive pay and performance?"; "How does the company use employment agreements?"; "Are severance and/or change-in-control provisions reasonable?"; "Is the company's compensation peer group appropriate?"; "Are the performance criteria and target goals appropriate?; "Is there significant compensation disparity between top executives?"; "What perquisites are given to executives?"; "Is the compensation disclosure clear and complete?"; and "Is the board amenable to investor input on compensation issues?" CHALLIE DUNN ET AL., RISKMETRICS GROUP, EVALUATING U.S. COMPANY MANAGEMENT SAY ON PAY PROPOSALS 6-9 (2009), http://www.riskmetrics.com/system/files/private/EvaluatingMgmtSayonPayProposals.pdf.

311. *See* American Recovery & Reinvestment Act of 2009, sec. 7001, § 111(f)(1), 123 Stat. 115, 520.

assistance" under TARP.[312] Kenneth Feinberg was then appointed Special Master. His responsibility extends to reviewing the compensation structure of the CEO and the top 100 most highly compensated employees of these seven institutions to determine whether it is inconsistent with the purposes of EESA or otherwise contrary to the public interest.[313] The Special Master has also been empowered to issue advisory opinions on requests submitted by TARP recipients, or by their employees, of the appropriateness of compensation arrangements.[314]

### 5. Current Status of TARP Recipients

As of June 2009, 32 entities have repaid some or all of their TARP payments. Most of the substantive EESA requirements (e.g., bonus and golden parachute payments) cease to apply once all the TARP is repaid. Executives of TARP recipients have certainly been vocal about the TARP executive compensation limits. According to JPMorgan CEO Jamie Dimon, receiving TARP funds has become a "scarlet letter."[315] Similarly, BB&T CEO Kelly King criticized the government's investment as "destructive," and said that the company's goal was to repay the TARP money "as soon as it is humanly possible."[316] From their vantage point, the government had gone too far in its reaction to excessive executive compensation arrangements.

### 6. The Administration's Proposal

In response to the recent financial crisis and the ongoing outcry over excessive executive compensation, the Obama Administration has turned its attention to reform.[317] On June

312. *See* TARP Standards for Compensation and Corporate Governance, *supra* note 262, at 28,416.

313. The seven institutions receiving "exceptional assistance" under TARP were American International Group, Inc., Bank of America Corp., Citigroup Inc., General Motors, GMAC, Chrysler, and Chrysler Financial. *See* Press Release, U.S. Dep't of the Treasury, The Special Master for TARP Executive Compensation Issues First Rulings (Oct. 22, 2009), *available at* http://www.treas.gov/press/releases/tg329.htm.

314. *See* TARP Standards for Compensation and Corporate Governance, *supra* note 262, at 28,416.

315. Elizabeth Hester et al., *JPMorgan Leads U.S. Banks Selling $8.7 Billion of Common Stock,* BLOOMBERG, June 2, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aN8GiTzvWJA8.

316. Matt Egan, *BB&T Doesn't Want "Destructive" TARP Cash,* FOXBUSINESS, Apr. 17, 2009, http://www.foxbusiness.com/story/markets/industries/finance/maryland-bank-gives-tarp-funds.

317. *See* Press Release, Statement by Treasury Sec'y Timothy Geithner on Executive Comp. (June 10, 2009), *available at* http://www.ustreas.gov/press/releases/tg163.htm [hereinafter Geithner].

10, 2009, Treasury Department Secretary Geithner identified the following five broad-based principles that the administration advocates to "better align compensation practices—[for all public companies, but] particularly in the financial sector—with sound risk management and long-term growth."[318]

- **Compensation Plans Should Properly Measure and Reward Performance.** On this point, the Secretary supports the notion of tying executive pay to performance, but he recognizes the folly of setting low targets to create easily attainable goals or the use of measures that do not necessarily correlate with the financial success of a firm.[319] Without providing specifics, the Secretary noted that "performance-based pay should be conditioned on a wide range of internal and external metrics, not just stock price."[320] One presumes that more guidance on such appropriate metrics will be forthcoming.
- **Compensation Should be Structured to Account for the Time Horizon of Risks.** In this instance, the Secretary expressed concern that many financial institutions had relied upon complex strategies that accrued short-term gains while producing long-term risks.[321] Rather than relying on clawbacks or other such mechanisms, Secretary Geithner stressed that compensation should be dependent on a long-term performance horizon, while recognizing that different "settings and industries" might accomplish this differently.[322]
- **Compensation Practices Should be Aligned with Sound Risk Management.** Stating the view that structure of compensation arrangements often encourages excessive risk taking, the Secretary calls on compensation committees to "conduct and publish risk assessments of [executive] pay packages . . . ."[323]
- **We Should Reexamine Whether Golden Parachutes and Supplemental Retirement Packages Align the Interests of Executives and Shareholders.** Noting that the use of golden

318. *Id.*
319. *Id.*
320. *Id.*
321. *Id.*
322. *Id.*
323. Geithner, *supra* note 317.

parachute arrangements have expanded well beyond their initial use as a defense to hostile takeovers, Secretary Geithner expresses concern that these arrangements no longer enhance firm value; and, he recommends that further review is required.[324] The same can be said for supplemental retirement packages, where it can be difficult for shareholders to understand the full value of the benefit.[325]

- **We Should Promote Transparency and Accountability in the Process of Setting Compensation.** Finally, the Secretary traces the misalignment of executive risk and reward to both a lack of clarity among shareholders and a lack of independence of board compensation committees.[326] Promising this clarity through say-on-pay legislation, the Secretary offers a solution that is reminiscent of the approach used in the ARRA amendments to EESA § 111.[327] With respect to the compensation committee, the Secretary envisions a legislative grant of authority to the SEC to implement Sarbanes-Oxley-like standards designed to assure committee independence.[328]

In closing his address, Secretary Geithner reiterated that the intent of these principles was not to cap pay, but instead to "develop standards that reward innovation and prudent risk-taking, without creating misaligned incentives."[329] In the days since this address, no further guidance has been provided for the first four principles above. As promised, however, the legislation has been introduced to address the final principal.

7. Future Legislatives Initiatives

To this end, the Obama Administration would attempt to pass legislation in two areas:

- Say-on-pay votes for publicly held corporation, whereby the shareholders would be given an annual advisory, non-binding vote on executive pay packages (salary,

---

324. *Id.*
325. *Id.*
326. Id.
327. Id.; see Ellen Sueda et al., United States: Besides COBRA: What Does the Stimulus Package have for Employers, LITTLER, Feb. 24, 2009, http://www.mondaq.com/unitedstates/article.asp?articleid=74924.
328. Geithner, supra note 317.
329. Id.

bonus, and other compensation) for executives, including severance arrangements;[330] and

- Independence requirement for the compensation committee of the board of directors, similar to the standards that exist for the audit committees as a result of SOX.[331] This would include extending to the compensation committee the resources to hire their own independent compensation consultants and outside counsel.[332]

Clearly the Administration believes that corporate governance will be reformed if shareholders are empowered with a vote regarding executive compensation packages.[333] However, during 2009, 300 companies had a say-on-pay proxy proposal, most of whom were TARP recipients. Of these 300 companies, no employer had a negative majority vote on the issue.[334] The requirement of independence of the compensation committee depends on the definition of independence. Certainly the goal is to avoid having the compensation committee beholden to management and therefore not necessarily protecting the best interests of the shareholders.

On May 19, 2009, Senator Charles Schumer (D-N.Y.) and Senator Maria Cantwell (D-Wash.) introduced legislation, titled Shareholder Bill of Rights of 2009, in the Senate requiring all public companies to implement say-on-pay voting.[335] That bill required a number of other corporate governance reforms:[336]

- Extending to shareholders a non-binding vote on executive severance packages payable upon a merger or acquisition;

---

330. *See* Corporate Executive Compensation Accountability and Transparency Act, S. 2866, 110th Cong. § 4 (as introduced by Sen. Harry Reid, acting on behalf of Sen. Hillary Clinton, Apr. 15, 2008), *available at* http://www.govtrack.us/congress/billtext.xpd?bill=s110-2866; Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. § 2 (2007).

331. Geithner, *supra* note 317.

332. *Id.*

333. *See* Corporate Executive Compensation Accountability and Transparency Act, S. 2866, 110th Cong. § 4; Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. § 2 (2007); Geithner, *supra* note 317.

334. *See* Mark A. Borges, Remarks at A.L.I.-A.B.A. EXEC. COMP. COURSE (June 18, 2009) (DVD available at A.L.I.-A.B.A.) (According to Mark Borges, the SEC proxy filings disclosed that there were six say-on-pay proxy proposals for 2006, 50 for 2007, 84 for 2008 and 103 in 2009. One-quarter of these employers received more positive votes than negative votes).

335. S. 1074, 111th Cong. (2009).

336. *Id.* §§ 3-5.

- Providing access to shareholders who own at least 1% of the company's stock proxy access to nominate directors;
- Reelection of directors annually, subject to the requirement that he/she receive a vote of 50% or more in uncontested elections;
- Requirement of an independent board chairman (hence, CEO cannot serve as chairman); and
- Creation of a risk committee of the board.

A similar bill was introduced by Representative Gary Peters (D-Mich.) in June 2009.[337] At the same time, Senator Richard Durbin (D-Ill.) introduced legislation requiring a "supermajority shareholder vote" for any executive compensation package that equaled or exceeded 100 times the average compensation payable to employees at the company.[338]

Based on the say-on-pay legislation passed by the House in 2007 and the Treasury's broad-based principles, Congressman Barney Frank (D-Mass.) introduced in the House of Representatives the Corporate and Financial Institution Compensation Fairness Act of 2009,[339] amending the Securities and Exchange Act. Its goal is to provide shareholders with an advisory vote on executive compensation and to prevent perverse incentives in the compensation practices of financial institutions. The bill was approved by the House, along party lines by a vote of 237 to 185.[340] The four major parts of the bill include:

- Say-on-pay: All public companies would be required to have an annual shareholder non-binding vote regarding executive compensation arrangements and a shareholder non-binding vote regarding golden parachute arrangements.[341] However, the SEC could provide for exemption for various categories of public companies, such as small businesses.[342] The annual say-on-pay and golden parachute votes by all institutional investors would have to be reported, unless they are already reported publicly according to

---

337. H.R. 2861, 111th Cong. (2009).

338. S. 1006, 111th Cong. (2009).

339. H.R. 3269, 111th Cong. (2009), *available at* http://www.govtrack.us/congress/billtext.xpd?bill=h111-3269.

340. Final Vote Results for Roll Call 686 on Corporate and Financial Institution Compensation Fairness Act, *available at* http://clerk.house.gov/evs/2009/roll686.xml.

341. H.R. 3266, 111th Cong. § 2 (2009) (adding subsections (i)(1) & (i)(2)(A) to § 14 of the Securities Exchange Act of 1934).

342. *Id.* (adding subsections (i)(5) to § 14 of the Securities Exchange Act of 1934).

SEC rules.[343] Originally, the bill contained a provision stating that compensation that was approved by a majority say-on-pay vote would not have to be subject to clawback provisions except in accordance to a contract with the executive or due to fraud; however, this provision was struck by the House of Representatives.[344]

- Compensation committee independence: All public companies are required to have compensation committees that are made up of independent directors, as determined by SEC standards. A separate provision may be made for small companies whose boards may not have separate compensation committees. The compensation committee shall have the authority to retain and obtain the advice of independent compensation consultants and counsels/advisors.
- Enhanced compensation reporting to reduce perverse incentives: For financial institutions with more than $1 billion in assets, there will be required disclosure of all compensation structures that include any incentive based criteria. In consultation with the Federal Reserve Bank, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift supervision, National Credit Union Administration Board, SEC and Federal Housing Finance Agency, standards will be formulated to judge incentive based compensation standards for risk assessment.
- The General Accounting Office (GAO) will also study the correlation between compensation structure and excessive risk-taking.

8. Federal Reserve's Initiatives

Under a recent proposal, the Federal Reserve Board has proposed to require banks to submit their salary and bonus policies for review to ascertain whether compensation is

---

343. *Id.* (adding subsection (i)(3) to § 14 of the Securities Exchange Act of 1934).

344. James Hamilton, *House Passes Corporate Governance Legislation with Say-on-Pay Mandate*, CCH FINANCIAL CRISIS NEWS CENTER, July 31, 2009, http://www.financialcrisisupdate.com/2009/07/house-passes-Corporate-governance-legislation-with-say-on-pay-mandate.html.

improperly aligned with excessive risk.[345] Such review would apply to tens of thousands of bank employees nationwide—ranging from CEOs to traders and loan officers.[346] The 25 largest U.S. banks would be subject to stricter scrutiny.[347] The Federal Reserve Board believes it has the legal power to subject banks to this level of review, but many were surprised that the scope of such review would extend beyond the top executives.[348] The proposal is likely to insist on clawback provisions to punish employees who took excessive risk.

The proposal is still in its infancy and would require a vote of the central bank's board, instead of congressional approval.[349] However, the concept of disclosure of incentive compensation arrangements to regulators is a topic that will likely be hotly debated in Congress.

## III. CONCLUSIONS

In light of the current financial markets and high unemployment rate, there will be continued scrutiny by the public and Congress on executive compensation packages that do not focus on performance and do not take a long-term view approach on return for investors. Recent congressional legislation has also highlighted distain for executive deferred compensation, even though the maximum limits under qualified retirement plans are inadequate to fund suitable replacement income for executives. Deferred compensation plans align the executive's actions with the long-term financial health of the employer.

The pay package for CEO J. Michael Pearson from Valeant Pharmaceuticals International recently drew praise as a model for other public companies. Under his compensation agreement, he is required to buy at least $3 million in stock, forgo routine annual equity grants and hold many shares for years before selling. If the company's share price increases at least 15% a year through February 2011, he can retain a portion of the restricted stock; until then, he cannot sell or exercise the stock

345. Damian Paletta & Jon Hilsenrath, *Bankers Face Sweeping Curbs on Pay,* WALL ST. J., Sept. 18, 2009, at A1.

346. *Id.*

347. *Id.*

348. *Id.*

349. *Id.*

options.[350] Whether we see a trend in this direction remains to be seen.

Recently contemplated legislative and regulatory proposals are making their way through the SEC rules (applicable to publicly listed employers) and part of "best practices" corporate governance. These rules and practices include:

- Performing a risk analysis regarding executive compensation packages, and disclosing the fact that the board or the compensation committee of the board performed such analysis;[351]
- Imposing clawbacks if executives are found to have manipulated earnings to inflate their pay; and
- Disclosure of compensation consultants' other engagements with the employer.

Other proposals that will likely have to wait until some future time:

- TARP's limitations on bonuses, golden parachutes payments, and tax gross-ups are unlikely to be adopted and imposed on publicly held employers. However, to the extent the say-on-pay proposal becomes law, negative votes by institutional investors and shareholders will undoubtedly put pressure on the entity's compensation committee to reconfigure the executive pay package (e.g., elimination of tax gross-ups).
- Disclosure of luxury expenditures that exceed $25,000 in value and the rationale for such perquisites is unlikely to be adopted and imposed, except to the extent the SEC forces it into the CD&A. However, employers may impose internal dollar caps on what they will pay for such expenditures, especially if the payment is for quasi personal/business use.

While the SEC certainly has the authority to demand transparency and disclosure of public companies through their proxy statements, it has been stretching its authority in recent years in hopes that greater disclosure will force boards of directors to change their governing practices. This is, of course, in light of the fact that many believe the SEC to be highly

---

350. Joann S. Lublin, *Valeant CEO's Pay Package Draws Praise as a Model*, WALL ST. J., Aug. 24, 2009, at B4.

351. *See generally* COMM. ON CORP. GOVERNANCE, THE COMBINED CODE: PRINCIPLES OF GOOD GOVERNANCE AND CODE OF BEST PRACTICE § 1.B (2002), http://www.fsa.gov.uk/pubs/ukla/lr_comcode3.pdf. It is not clear whether such analysis must be done annually or semi-annually from a best practice perspective.

ineffective, a belief brought to the forefront by the lack of investigation of Bernard Madoff and R. Allen Stanford, despite tips brought to its attention.[352] As disclosure to the SEC of the Madoff and Stanford scandals did not change SEC's behavior, it is not clear that disclosure of corporate pay practices will result in changes within corporations. As of now, the Administration and Congress have been relying of the SEC's regulatory power under its "sunshine" powers. The author cautions continued use of the federal tax code to curb the amount and the type of executive compensation, not only in lights of its prior failures, but also because it has had unintended consequences.

352. *See* Clifford Krauss, *2 Regulators List Lapses on Madoff and Stanford*, N.Y. TIMES, Oct. 3, 2009, at B2 (reporting that an internal review by the Financial Industry Regulatory Authority concluded that the SEC did not investigate tips that might have disclosed the frauds of Bernard L. Madoff and Texas billionaire R. Allen Stanford. Such report affirms the SEC inspector general's conclusion that the agency mishandled inquiries regarding Mr. Madoff from 1992 to 2008); *see also* Memorandum to Mary L. Shapiro from H. David Kotz, Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC (Sept. 29, 2009), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2009/468.pdf (stating the FTI Engagement Team found the OCIE examiners made critical mistakes in nearly every aspect of their investigation of Madoff).